Preface

Why Entrepreneurial Finance Matters

About eight years ago, in the middle of one of my entrepreneurial finance classes, a student abruptly announced to the class that he didn't need to learn what I was teaching because his mother was going to fund his business. He then got up from his seat and walked out of the classroom.

Three weeks later, this same student reappeared in my classroom. To his credit, at the beginning of class, he put up his hand, hopeful for an opportunity to speak. When I called on him, he announced that, yes, he was back in the classroom—and this time he was ready to learn. I asked him why he had changed his mind and come back to class. I'll never forget the reaction of the class when he said, "My mom said she's not giving me a dime to start my business until I can convince her it will be profitable."

Exactly, young man.

The Need for a Real-World Approach to Entrepreneurial Finance

Eleven years ago I was tasked with teaching my first entrepreneurial finance class. I was genuinely enthusiastic about the challenge, but immediately ran into a road block: I couldn't find an entrepreneurial finance textbook that spoke to the true nature of entrepreneurial finance.

As an experienced entrepreneurship instructor with a background as both a CPA and a serial entrepreneur, I knew what I wanted to teach. I wanted to speak to the realities of entrepreneurship and finance as I had experienced them. The textbooks I found, though they definitely had some good qualities, did not address the following:

- the fact that most entrepreneurs make decisions for their companies based, at least in part, on their personal finances and personal goals (this is one of the reasons entrepreneurial finance is so different from traditional business finance)
- how to create the pro forma financial statements an entrepreneur needs to get their business funded
- how to manage wealth (this is especially important to learn if you've never before had any wealth to manage)

I refer to this textbook as practical because it thoroughly addresses all three of the above real-world realities.

Key Features of This Textbook

Chapter organization that honors the journey of the entrepreneur

I start the book by talking about the entrepreneur as an individual, before they start a company. I then focus on how to start, fund, manage, grow, and eventually harvest cash from a business. I end the book by talking again about the entrepreneur as an individual, but this time as an individual who has achieved personal wealth as a result of building a successful company.

Specifically, the first part of the book, Chapters 1–3, focuses on the education, research, planning, and decision making an individual should undertake before starting a business. The chapters discuss

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entrepreneurial failure and what the entrepreneur can do to both minimize the risk of failure for their business and also protect themself as an individual.

Understanding the numbers associated with business isn't a strong point for most entrepreneurs. As a result, at their peril, they tend to avoid learning to read, understand, and create financial statements. The second part of the book, Chapters 4–8, addresses this lack of understanding by both teaching the basics about traditional financial statements and demonstrating a step-by-step process for creating pro forma financial statements.

The third part of the book, Chapters 9–11, demonstrates the basic tools needed to manage a business and make informed decisions for that business. The topics addressed include bootstrapping, proper working capital management, placing appropriate controls over the assets of a business, and how to appropriately choose between the many business opportunities and investments that are constantly presented to business owners.

The fourth part of the book, Chapters 12–15, focuses on how to value a business, how to sell a business (if that result is desired), how to harvest cash from a business (in ways other than selling it), and how to properly manage the personal wealth that often results from successful entrepreneurship. The discussion of personal wealth management effectively closes the loop of the book's discussion of entrepreneurship by bringing us back to once again looking at the entrepreneur as an individual, but this time after they have achieved personal wealth as a result of building a successful company.

Chapter features that keep the student organized and engaged

- Entrepreneur in Action segments—short stories that illustrate the use of chapter concepts by entrepreneurs in their day-to-day activities
- Learning objectives—help the student and instructor focus on the goals for the chapter
- Figures—consist primarily of the financial statements, schedules, and analyses most often needed and created by an entrepreneur
- Key terms—are highlighted and defined within the chapter and appear again in the glossary
- Review and Discussion Questions—designed for use in class or to be assigned as homework in order to make sure the students have grasped the concepts of the chapter
- Exercises—designed to be assigned as homework to reinforce the learning objectives listed at the start of the chapter. These give the student practical experience performing the analyses and creating the financial statements they will need as entrepreneurs.

End-of-chapter appendices that include comprehensive examples that are nearly impossible to find in the real world

The Chapter 7 appendices illustrate the creation of pro forma financial statements for a service-based business and a complex, smart phone application business.

What's New in the Second Edition

Overall, in order to make the job of the instructor easier, the first edition has been restructured to feature 15 chapters instead of 12. Specifically, Chapters 6, 11, and 12 have been divided into two chapters each. This change improves the flow of an entrepreneurial finance class by providing for chapters that are both more equal in length and more distinct in content.

Also, to better engage the student's interest, each chapter starts with a short story, called an "entrepreneur in action," about an entrepreneur encountering a problem. Most of these stories are based on real world events I either experienced myself as an entrepreneur or witnessed other entrepreneurs experiencing. The chapter then discusses or illustrates the solution to the problem and finally returns to provide the (not always happy) ending to the story. Note that the names of all the individuals and companies involved in the entrepreneur in action stories have been changed to protect the guilty.

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In addition, beyond just generally updating the chapter content, the organization of each chapter has been improved in that the chapters have been streamlined to more clearly tie to the chapter learning objectives. Also, in addition to updating the first edition end-of-chapter review and discussion questions and exercises, at least one new end-of-chapter review and discussion question or exercise has been added to each chapter. In over half of the chapters, *many* new end-of-chapter review and discussion questions and exercises have been added.

Last, the instructor will note a marked increase in the amount of research supporting the textbook. One reason for this is because there have been significant changes in the regulatory considerations surrounding many sources of entrepreneurial funding, especially crowdfunding. Also, with each passing year, the tax code becomes increasingly complex. For this reason, beyond just presenting the latest information regarding the U.S. tax environment, this textbook provides the reader with an increased number of resources they can consult in the future for updates as the tax environment continues to evolve.

Additional Teaching Resources

Visit **collegepublishing.sagepub.com** and navigate to the Resources tab on your book's page to find the teaching materials designed to accompany this textbook. On this site you will find an array of materials that will save you time and help you keep students engaged, including:

- A test bank for every chapter that:
  - covers every learning objective and key term for each chapter
  - presents multiple-choice and true/false questions that are compatible with any learning management system
  - includes questions that require the student to apply their knowledge—questions similar to the end-of-chapter exercises
- The instructor's manual, which offers a wide range of customizable teaching and learning content for all chapters, including:
  - Chapter outline
  - Learning objectives
  - Chapter summary
  - Answers to the end-of-chapter review and discussion questions and exercises
- PowerPoint® slides that include key chapter figures and provide key chapter topics in an outline form
- Tables and Figures from the book are available to support lecture preparation and class discussion
- Sample course syllabi include suggested models for structuring your course

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Chapter 1

Proper Preparation and the Nascent Entrepreneur

Learning Objectives

After completing this chapter, you should be able to:

1.1 Describe how entrepreneurial finance is different from traditional business finance.

1.2 Explain how a business plan is different from a feasibility analysis and why an entrepreneur should always do a feasibility analysis before starting a business.

1.3 Discuss how an entrepreneur can financially sustain himself during the start-up phase of his business.

1.4 Identify what specifically an entrepreneur can do to separate himself from his business.

1.5 List the top legal and financial mistakes entrepreneurs make.

Entrepreneur in Action 1.1: Leigh Dawson's CoffeeCo Contract Conundrum

Leigh Dawson was about to purchase CoffeeCo, a company that provides sustainably sourced coffee to independent coffee shops across the United States and Canada, from its founder, Steve Sampsel. Steve, who had started the company 10 years ago, though still a relatively young man at age 55, had told Leigh he wanted to sell the company because he was ready to retire from full-time work. After 5 months of negotiation regarding price and many other terms associated with the owner-financed purchase/sale, Leigh and Steve had reached a verbal agreement. Steve told Leigh he had advised his attorney to prepare a purchase/sale agreement based on he and Leigh's verbal agreement. Last week, Steve suggested that he and Leigh meet at CoffeeCo's company headquarters to review the purchase/sale agreement and finalize the deal with he and Leigh's signatures.

Leigh was a little nervous about the purchase because not only had she never purchased a business before but she had also never purchased anything using owner-financing. Still, she knew that buying a business using owner-financing was not unusual and was generally considered a perfectly acceptable way to finance the purchase of a business, assuming all the relevant terms of the deal are carefully negotiated to the satisfaction of all parties involved.

With regard to the $1,000,000 sales price, Leigh had negotiated a 20% down payment, with the remainder of the purchase price to be financed by Steve over 7 years at 5% interest. No principal was due to be repaid until the end of year 7, but if Leigh was able to successfully grow the business and increase its profits accordingly, Leigh had negotiated with Steve that she could repay him in part or in full at any time up to and including the end of the 7-year period. Leigh had made sure of this eventuality by requesting that an early repayment option be included in the agreement. Leigh now arrived at CoffeeCo's company headquarters, as Steve had requested.

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Steve walked Leigh to the conference room of CoffeeCo's company headquarters, placed a cup of CoffeeCo's signature blend coffee in front of her, and then handed her the purchase/sale agreement. Leigh started to read it. Leigh began to feel awkward as Steve sat and watched her read the agreement, but Leigh had been educated by her father to always be thorough in her business dealings. Steve interrupted Leigh's reading after a few minutes and asked her if everything was okay. Leigh replied that, yes, everything was fine, so far. Steve commented that the agreement reflected what he and Leigh had previously agreed upon verbally. Leigh said she was sure that it did, but she liked to be thorough and completely read documents before signing them. Steve noted that it was almost time for him to meet his wife for a celebratory dinner down the street at Angelo's Bistro. Leigh began to feel really uncomfortable, like a rookie businessperson who was being unreasonable making Steve sit and wait while she insisted on reading every word of the lengthy agreement. Steve went to the room next door, called his wife, and started talking to her about what they might order at the restaurant to celebrate the sale of CoffeeCo. Then Leigh overheard Steve tell his wife that Leigh was "being ridiculous," which only made Leigh feel even more self-conscious.

As you read this chapter, think about the situation Leigh finds herself in and how you might react under similar circumstances. We'll return to Leigh's conundrum later in this chapter to see what happens next.

Entrepreneurship and Entrepreneurial Finance

LO 1.1	Describe how entrepreneurial finance is different from traditional business finance.

The personal finances of the nascent entrepreneur and the finances of the start-up venture he creates are inextricably linked. This is true for the following reasons:

- Most new ventures benefit from a significant financial investment from their founders.
- Many founders personally guarantee the debt or contracts of their young start-ups.
- Most new ventures are founded as pass-through entities. A **pass-through entity** is a business whose profits are not taxed at the company level but instead pass through to the business owners' personal tax returns, where they are taxed.

Beyond the fact that one discipline focuses on starting a new business and the other focuses on managing an existing business, it is the depth of the relationship between the entrepreneur's personal finances and the finances of the entity he creates that makes entrepreneurial finance fundamentally different from traditional business finance. **Entrepreneurial finance** is the study of resource acquisition, allocation, and management; financial planning and management; asset and business valuation; cash harvest strategy; and contingency planning in the context of a new business venture and the entrepreneur's personal financial goals. In other words, the topic of entrepreneurial finance recognizes that, oftentimes, entrepreneurs make decisions for the businesses they've founded with their personal financial goals—and other personal goals—clearly in mind. Arguably, the relationship between a start-up venture and its founders is most pronounced when the venture is only a concept being contemplated, researched, and considered. Rare is the entrepreneur who doesn't consider his personal financial and professional future when deciding whether or not to actually start a new venture.

Unfortunately, the rate of new venture failure is notoriously high in all industries. It's interesting to note, however, that the percentage of new businesses that fail within the first 5 years does, in fact, vary by industry. Business failure rates within the first 5 years for selected industries are illustrated in Figure 1.1.

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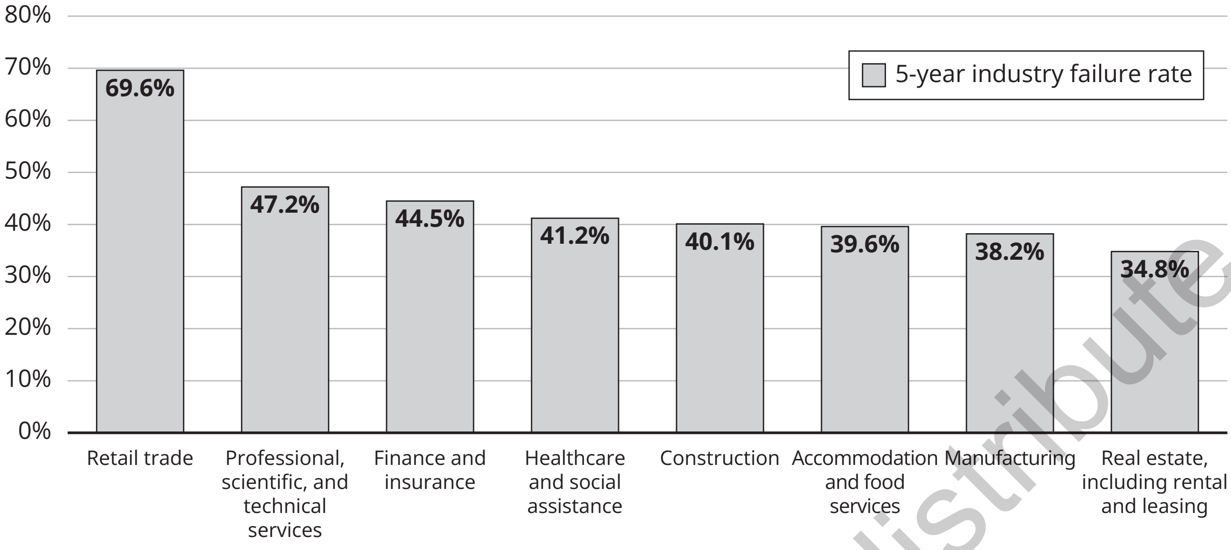
Figure 1.1 ▪ Business failure rates within the first 5 years for selected industries.



Source: Adapted from: "The Percentage of Businesses That Fail – and How to Boost Your Chances of Success" by Devon Delfino, Lending Tree, May 8, 2023.

Having noted both the unique relationship between a founder and his start-up, and the high failure rate associated with new ventures, what should a nascent entrepreneur consider when deciding whether or not to pursue starting a company? What can an individual do to increase his chances of entrepreneurial success?

The answers to these questions will, of course, vary dependent upon the nature of the individual entrepreneur and the business concept under consideration, but there are two major causes of business failure that, with some effort on the part of the entrepreneur, are, in many cases, avoidable: poor timing and lack of proper preparation. That said, whether because of poor timing, lack of proper preparation, or another factor, the mistakes that most severely damage a business tend to be either legal or financial. With the goal of improving the entrepreneur's chances for new venture success, the remainder of this chapter will discuss the optimal timing of the start of an entrepreneurial venture, the preparation an entrepreneur should undertake before—and at the time of—starting a new venture, and the top legal and financial mistakes an entrepreneur should avoid making. Let's start our conversation by talking about timing.

Timing

In a March 2015 TED talk, Bill Gross, founder of Idealab, said that after gathering and studying data from hundreds of companies, he had found one factor that seems to affect a start-up company's prospects for success more than any other: timing.[1] Often the timing of the start of an entrepreneurial venture is driven by trends in the market the concept will serve. Other times, it is driven by the innovation associated with the concept itself or innovation in the environment in which the concept will exist or function. Still other times, it is driven by the entrepreneur himself. It is important to note that, no matter what the reasoning behind it, poor timing is the enemy of the entrepreneur.

Suppose that market research indicates that a certain product or service is currently trending favorably with a market. Usually, the companies that are able to adapt to the new trend quickly can take advantage of the opportunity and will likely flourish. On the other hand, those companies that are not able to adapt to the new trend quickly enough may suffer. For example, practically overnight, the onset of the COVID-19 pandemic exponentially increased the typical consumer's appetite for at-home testing, prescription delivery services, and telehealth. Prior to the pandemic, although many virtual healthcare options existed, consumers had generally not embraced these options, instead tending to remain loyal to the more traditional products and services with which they were already familiar.

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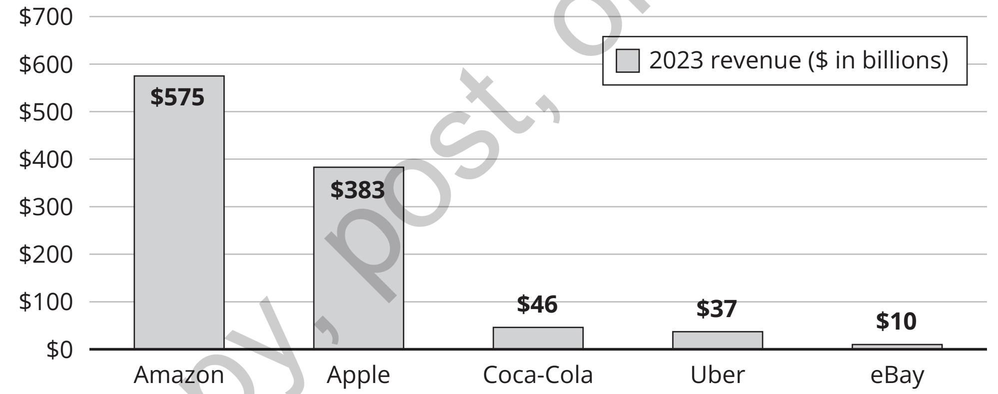
The pandemic presented healthcare organizations with the opportunity to rethink their digital offerings and develop solutions that better facilitated the virtual delivery of healthcare that consumers suddenly very much wanted. Prior to the pandemic, it didn't seem that the typical consumer was yet ready for a virtual healthcare experience. Once the pandemic manifested, the onus was on healthcare providers to either create—or greatly improve—their virtual healthcare offerings. Those healthcare providers that were able to adapt quickly flourished. Those healthcare providers that could not adapt quickly experienced either the loss of many customers or, in some instances, business failure.

Suppose that, instead of hopping on a trend, a concept is such that a first-to-market opportunity is available. A first-to-market opportunity generally suggests that the time to introduce a new product to the market is now. This is true because, while certainly no guarantee of success, conventional and anecdotal wisdom indicate that those who reach the market first with a truly innovative new product or service tend to be more profitable and better able to hold onto market share in the long run compared to later (copycat) entrants to the market. Examples like Amazon (which created the first online bookstore), Apple (which created one of the first mass-produced microcomputers), and the other companies featured in Figure 1.2 certainly illustrate the attractiveness of a first-to-market opportunity. In certain instances, a first-to-market opportunity can be enticing enough to compel an entrepreneur to start a new venture at a time that is actually personally inconvenient for the entrepreneur. There is nothing really wrong with this as long as the entrepreneur is otherwise well prepared.

Figure 1.2 ▪ Top first-to-market companies, ranked by revenue ($ in billions).



Source: Yahoo Finance.

Generally, the timing is right to start a business when both the customer—and the environment surrounding both the business concept and the customer—are ready for what the entrepreneur has to offer. If either the customer or the environment isn't ready, no matter how well the entrepreneur executes, the likelihood of entrepreneurial failure is high.

Preparation

Now that we've discussed timing, let's talk about preparation. There is a lot to be said for the entrepreneur being properly prepared before starting a new venture. We've all heard the saying "Success is 90 percent preparation and 10 percent perspiration." Louis Pasteur noted that "Chance favors only the prepared mind." Abraham Lincoln said, "I will prepare and someday my chance will come." Quotes like these have staying power in our culture because they have proven over time to be fundamentally true. Appropriate preparation before you start a new venture, perhaps before you even have an idea for a new venture, will serve you well as an entrepreneur.

So, what should you do? How do you prepare?

Before starting a business, in order to increase his chances for entrepreneurial success, the aspiring entrepreneur should do the following:

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- Work in and learn about the industry in which he intends to start the business.
- Establish a large network both within and outside of the industry in which he intends to start the business.
- Complete a full feasibility analysis on the concept under consideration and, if deemed appropriate, also complete a business plan on the concept.
- Personally, financially prepare for the pre-revenue and pre-profit phases of the business.
- Learn the basics regarding how an entrepreneur should separate himself from his business.

Feasibility Analysis and the Business Plan

LO 1.2	Explain how a business plan is different from a feasibility analysis and why an entrepreneur should always do a feasibility analysis before starting a business.

The rate of new business failure would likely be significantly lower if every entrepreneur took the time to do a feasibility analysis that includes a breakeven analysis (breakeven analysis will be explained and illustrated in detail in Chapter 5) and a **business plan**—a comprehensive document that focuses on how to build a company, prepared by—and for the benefit of—the entrepreneurs involved, but written with an outside audience of potential investors, lenders, strategic partners, or major talent targets in mind. While it definitely increases an entrepreneur's chances of success, a significant number of successful businesses have, in fact, been started without a business plan, but no new business should be started without the founding team first completing a full feasibility analysis.

A **feasibility analysis** is a more narrowly focused document than a business plan as it concentrates on assessing the likelihood of economic success of a business, primarily for the benefit of the entrepreneurs contemplating starting that business. A feasibility analysis is performed to answer the following four questions:

1. Are there enough interested customers that a business based on the concept under consideration can actually turn a profit?
2. Is now a good time to introduce this product or service to the market? In other words, has the optimal time to introduce the concept already passed, or has it possibly not yet arrived?
3. Will a business based on the concept under consideration make enough of a profit to actually be worth undertaking considering both the financial and nonfinancial up-front investment required?
4. Can a quality cross-functional founding team be quickly and efficiently assembled in order to successfully get the product or service under consideration to market in a timely fashion?

A typical feasibility analysis includes the following major components:

- an executive summary, including the feasibility (i.e., "go" or "no go") decision
- a description of the business concept underlying the proposed business, which should include the following:
  - a detailed description of the proposed product or service
  - a description of the value the product or service will bring to its likely customers
  - a description of the product or service's likely customers
  - a description of the distribution channels that will most likely be utilized to get the product or service to its customers

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- a market (customer) analysis that includes a description of the product or service's first target customers
- an industry (competitor) analysis that clearly illustrates the product or service's competitive advantage
- a development plan that describes how the final version of the desired product or service will be realized over time
- a description of the existing or needed management team
- a financial plan that includes the following information:
  - a detailed accounting of the amount of start-up capital required by the business and how and when that start-up capital will be utilized
  - expected product pricing
  - expected customer demand
  - expected short- and long-term profitability
  - expected working capital needs (**working capital** is the capital required to sustain operations and support business growth after a company's start-up phase is completed)
  - existing and potential sources of capital for the business
  - the expected return on investment
  - a breakeven analysis that supports the proposed business's economic viability

  The financial plan is the element of the feasibility analysis that we'll focus on in this textbook. All of the above components of a financial plan will be fully explained and illustrated in Chapters 2–9.
- the expected timeline to launch, including objective milestones whose achievement will clearly indicate progress (or the lack thereof)

A feasibility analysis is critically important because it proves or disproves a new concept's viability in the marketplace (i.e., if enough customers will buy the product or service to make a business based on the concept viable). If there aren't enough expected customers to make the business concept viable, the answer regarding whether or not to start the business is clear. Assuming the feasibility decision is "go," the next step is to create a business plan. A business plan is more comprehensive than a feasibility analysis and discusses all the operational and financial aspects of a new business. In other words, a business plan focuses on how to build a company.

The major components of a business plan include all the components of a feasibility analysis, less the "go" or "no go" feasibility decision, with the breadth and depth of each section of the feasibility analysis being fleshed out and expanded by significant additional research. Specifically, a business plan should include the following modified or additional elements:

- the business concept, fleshed out in order to illustrate a comprehensive **business model** (a company's business model indicates how a business concept will make a company—and ultimately the entrepreneur—money)
- the expected operational and organizational structures of the business
- a marketing plan (emphasizing the plan for initial market entry)
- a growth plan
- pro forma financial statements for the first 3 to 5 years of the business (**pro forma financial statements** are financial statements that attempt to estimate the future financial situation of a company based upon certain identified assumptions)
- a cash harvest strategy, including contingency plans

Pro forma financial statements and cash harvest are elements of a business plan we will focus on later in this textbook. The business model element of a business plan we will take a moment to discuss here.

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A business model broadens and extends a business concept by answering the question: How will the company make a profit from the products and services suggested by the business concept? Specifically,

- How will value be created for all of the stakeholders associated with the business?
  - Will customers benefit from the competitive advantage offered by the business and its products and services?
  - Will jobs be created?
  - Will enough cash be generated to allow for payouts of cash to the company's owners?
  - Will lenders and creditors be repaid on a timely basis?
  - Will the company create shared value that benefits both itself and society—or will the company be purely profit-driven?

The entrepreneur should note that unsatisfied stakeholders usually don't stick around.

- How will competitive advantage be achieved? Significant sales revenue is rarely generated by a company without a clear competitive advantage.
- What are the nature, size, and relative importance of the revenue streams the business model will produce? The entrepreneur needs to identify a clear path for how the business will turn its investment in the products and services it will purchase, build, or develop back into cash to be received by the company in the form of revenue. Multiple revenue streams are preferable to one revenue stream.
- What costs most affect the business's ability to operate on both a short-term and long-term basis? Identifying a business's major costs early on—and understanding when and how those costs will be incurred—helps the entrepreneur plan appropriately regarding how to pay for and minimize such costs.
- Can the efficacy of the business model be sustained over time? In other words, will the planned business model sustain the company long term? If not, is the business model flexible enough to be adapted over time as necessary?

Two examples of business models with which many entrepreneurs are currently finding success are the subscription-based business model and the marketplace business model. Time is a finite resource for every individual and, because of real or perceived time poverty, consumers worldwide are increasingly embracing hassle-free shopping experiences. Evidence of this can be seen in the exponential growth in the number of businesses offering subscription-based products or services. For consumers, the value of the subscription-based business model lies in being able to easily set up the recurring delivery of a product or service, knowing the cost of that product or service will not change without warning and knowing the desired product or service will arrive as scheduled, without the time and trouble of reordering. For start-up businesses, the value of the subscription-based business model lies in the ability of a business to start small and grow in a controlled fashion. For more mature businesses, the value of the subscription-based business model lies in the business being able to fairly accurately predict future revenues due to the subscription-based business model's naturally occurring high rate of repeat sales. HelloFresh, Stitch Fix, and Dollar Shave Club are examples of some of the top subscription-based product businesses. Netflix, MasterClass, and Spotify are examples of some of the top subscription-based service businesses. Figure 1.3 illustrates the large number of subscribers a successful subscription-based service business can capture.

A business operating under the marketplace business model is primarily engaged in bringing consumers and the businesses that serve them together in a more convenient fashion than was previously available. A marketplace business facilitates transactions between others, making money by either charging a small fee or taking a small portion of the revenue related to each transaction. Uber has successfully created a marketplace where strangers rent rides from strangers. Airbnb has successfully created a marketplace where strangers rent accommodations from strangers. Amazon has successfully created a marketplace where strangers buy products from strangers. The challenge of the marketplace business model for a start-up business is the need to quickly establish trust and achieve a broad user base. However, once they are established, as long as both trust and the broad user base are adequately maintained, a marketplace business generally continues to be successful.

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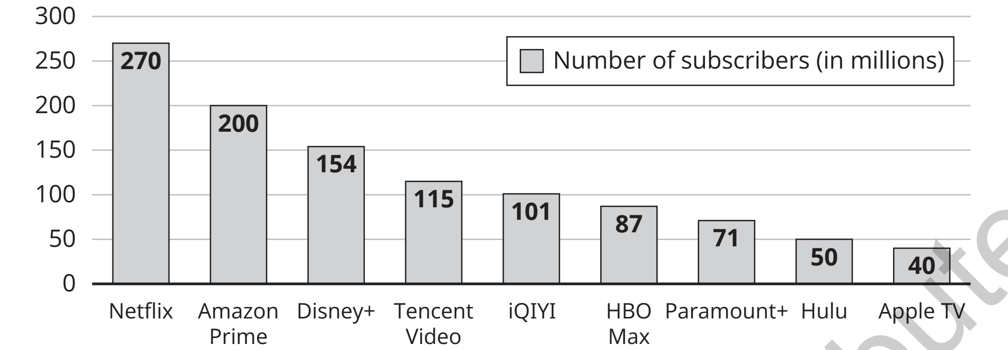
Figure 1.3 ▪ Streaming service companies, ranked by number of subscribers (in millions).



Source: Adapted from: "Top Streaming Services by Subscribers," FlixPatrol, https://flixpatrol.com/streaming-services/subscribers/, accessed July 16, 2024.

Personal Financial Preparation

LO 1.3	Discuss how an entrepreneur can financially sustain himself during the start-up phase of his business.

Before starting a business, entrepreneur, you should carefully consider three entrepreneurial realities:

1. Most new businesses require a substantial time commitment from the entrepreneur.
2. Most new businesses require a significant financial investment by the entrepreneur.
3. Many start-ups earn no revenue during their first year of operations, and more than half aren't profitable in their first year.[2]

Considering these realities, it's likely you'll increase your chances for entrepreneurial success if you're in a stable life situation—that is, if you're not making major life changes during your new venture's start-up period. Your new venture will likely require every spare moment you have to give it. And your new venture will also likely induce certain mental and physical stresses. A wise entrepreneur doesn't voluntarily lump the stresses associated with starting a business on top of avoidable personal stresses. A wise entrepreneur adjusts his life and frees up adequate time to pursue a new venture before starting that new venture.

Further, it's likely you'll increase your chances for entrepreneurial success if you're not worried about how you're going to pay your personal bills during your new venture's start-up phase. No potential investor in your company wants to hear that you need money to pay your personal bills or that you need a salary. Saying either of these things sounds unprofessional, and you'll appear to potential investors as having not adequately planned for the start-up phase of your new business.

Generally, you can sustain yourself personally during the start-up phase of your business utilizing one or more of the following resources:

- funds you already have
- income you earn on an ongoing basis from a job or another existing business you may own
- strategic expense minimization
- funds you borrow

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Some entrepreneurs have a cache of money they can dip into to survive during the start-up phase of their business. This is usually money they've saved or, perhaps, money they've inherited. Other entrepreneurs, in order to survive, work a job or operate another existing business at the same time they're starting a new business. Still others engage in strategic expense minimization or live off credit cards and other forms of debt until their new business becomes profitable enough that they can start withdrawing cash from the business.

Strategic expense minimization is a process in which many entrepreneurs engage before starting a business with the goal of minimizing expected future outlays of cash. Strategic expense minimization involves making your dollars serve you twice—once for business purposes and once for personal purposes—by investing in assets you can share with your business. Examples include turning the top floor of a building rented by your business into your personal residence, using a business vehicle for personal use instead of having a personal vehicle, and using a business smartphone during off hours as your personal smartphone instead of having a separate personal smartphone.

Strategic expense minimization involves:

- reviewing all of your personal expenses
- determining which are the largest—and thus the most attractive to minimize or eliminate
- determining which expenses can, in fact, be minimized or eliminated—and how
- actually executing the process of minimizing or eliminating the identified expenses

Strategic expense minimization involves truly embracing the entrepreneurial lifestyle when beginning a new venture. Strategic expense minimization often also simply makes good financial sense.

Imagine you're an entrepreneur who wants to quit your boring (but well-paying) day job and open a wine bar. How best could you do that?

First, you'd likely consider keeping your day job until the wine bar reaches the minimum level of profitability needed for you to pay your personal bills. Note that your personal bills will likely be significantly lower than your pre–wine bar days if you've engaged in some level of strategic expense minimization.

For example, is it really the best course of action to continue paying the mortgage on your house or the rent on your apartment during the start-up phase of this business? Might it make more sense, for many reasons, to live on the currently unoccupied second floor of the building your business is renting—the building in which you're about to open and operate your wine bar? (I'm guessing your own business would charge you reasonable rent.) And isn't it wise to be physically close to your business when it's in its infancy anyway? And if you have to share a vehicle and a smartphone in order to keep expenses low, wouldn't you prefer to share it with your own business?

As long as you keep diligent records of personal versus business use, sharing a vehicle or a smartphone with your business isn't a problem at all. In general, if you use your personal vehicle or smartphone 20% of the time for business, you can legitimately deduct 20% of your vehicle or smartphone's costs as a business expense. With regard to proper recordkeeping for the shared use of a vehicle, as a start, reference Internal Revenue Service [IRS] Publication 583 "Starting a Business and Keeping Records" and IRS Publication 463 "Travel, Gift and Car Expenses."[3,4] With regard to proper recordkeeping for the shared use of a smartphone, it is best to make sure you have itemized bills so you can prove the amount of your tax deduction to the IRS.[5] Remember, sharing assets with your business can significantly increase the speed with which you're able to successfully get your new business past the start-up phase and into a state of profitability so that you can quit that day job.

Next, let's consider the issue of taking on debt. For some budding entrepreneurs, as a practical matter, taking on personal debt is the only way they can get through the start-up phase of their business.

If You Must Rely on Debt

Debt is a useful tool that has historically helped many individuals and businesses achieve goals they otherwise couldn't. But debt is something that should always be thoughtfully considered before it is incurred. Before borrowing to support an entrepreneurial start-up, an entrepreneur should always

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consider if there are ways to achieve the desired goal without taking on debt. This is important because taking on debt is essentially spending money you haven't yet earned.

Some individuals have no viable alternative to taking on debt in order to pursue their entrepreneurial goals. If you must take on debt in order to pursue your entrepreneurial goals, be sure to do the following:

- Set a debt limit for yourself such that you can pay back the debt without major hardship should the business fail.
- Develop a budget detailing exactly for what (and only for what) the borrowed dollars will be used.

If you're going to rely upon debt, you're obviously going to need to find someone willing to loan you money. Depending on the lender, credit scores can often play an important role in your ability to borrow money.

Your Credit Score

If you're an entrepreneur seeking to borrow money, the personal credit histories of you and your business partners—if, in fact, you have business partners—are going to come under review. One of the first things any lender will look at is your credit score. Your **credit score** is a three-digit number, typically between 300 and 850, which is calculated from your credit report in order to gauge your reliability as a borrower. Your **credit report** is a detailed report of your credit history prepared by a credit bureau.

Lenders and other creditors use your credit score to predict whether you'll pay back your debts on time. Your credit score also helps determine whether you're generally a good risk for a lender (i.e., lenders use it to help determine the interest rate you will pay). Generally, the higher your credit score, the more likely it is you'll be able to get a loan when you need it—and at a reasonable interest rate.

In 1981, the Fair Isaac Corporation (FICO) created a branded version of your credit score called the FICO Score.[6] According to FICO, the FICO Score is the credit score most widely used by U.S. lenders to make loan approval decisions.[7] To compute credit scores, FICO uses information provided by the three major credit reporting agencies—Equifax, Experian, and TransUnion—but FICO itself is not a credit reporting agency. Each of the three major credit reporting agencies also computes a FICO credit score for you based on the FICO formula and the information that has been reported to them about you. This means you may have as many as four different FICO Scores, one computed by each credit reporting agency and one calculated by FICO itself.

It's interesting to note that the credit reporting agencies don't seek out information from creditors or lenders. They build your credit report based solely on the information voluntarily reported to them by creditors. Figure 1.4 shows the factors that determine the average person's FICO credit score.

The percentages in Figure 1.4 are based on the relative importance of the five categories for the general population. For individuals falling outside the general population demographic, the relative importance of these categories will be different.

Negative information adversely affects your credit score (i.e., lowers your score). Negative information includes bankruptcy, collection actions, foreclosures, and late payments. Fortunately, negative information stays on your credit report for only a certain period of time—usually 7 years—so positive behavior such as not taking on too much debt, not opening too many credit card accounts at one time, making on-time debt payments, and overall responsible credit use will improve your credit score over time.

A low credit score generally increases your difficulty in obtaining a loan. It also increases the interest rate you'll be charged on any debt you do obtain. If you plan to take on business partners, you should endeavor to select partners who have good credit. If you currently have bad credit and want to someday start your own business, you should immediately start working to improve your credit score by cleaning up your credit report.

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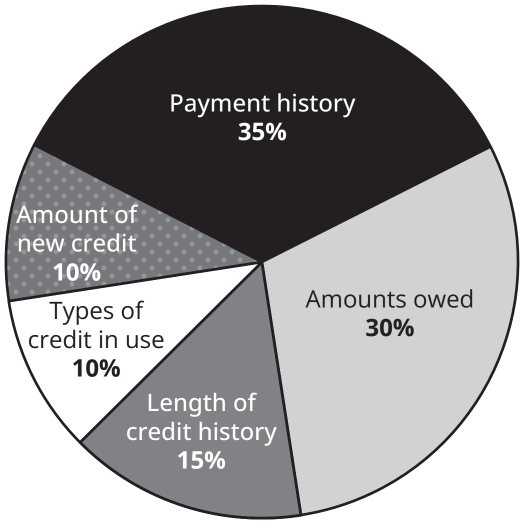
Figure 1.4 ▪ The factors that determine the average person's FICO credit score.



Source: Adapted from: Fair Isaac Corporation, "What's in my FICO scores?" 2023.

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Your Credit Report

Whether you have good or bad credit, it's important to check your credit report regularly. The following factors related to your credit report could negatively affect your credit score:

- The report could include inaccurate information.
- Some of your credit accounts could be missing from the report.
- Information that doesn't belong to you could be included on the report.

If you find inaccurate information, you should immediately file a dispute with the applicable credit reporting agency.

Another important reason to monitor your credit report is the very real threat of identity theft. Identity thieves who have access to too many pieces of your personal information (e.g., your social security number, date of birth, and home address) can take out loans in your name. They can also create other financial disasters you may be completely unaware of—until the Internal Revenue Service or a collection agency comes looking for you.

The Fair Credit Reporting Act requires Equifax, Experian, and TransUnion to provide you with a free copy of your credit report, at your request, once every 12 months. The most efficient way to access these credit reports is by using annualcreditreport.com. Many people make a practice of requesting one free credit report every 4 months and rotating these requests between the three major credit reporting agencies in order to keep a continuing eye on their credit report. For a small fee, typically less than $10, you can usually get access to your credit score when checking your credit report. If you want to have more regular access to your credit report and credit score and also have a credit reporting agency monitor your credit report, you might want to consider investing in a credit monitoring service offered by one of the three major credit reporting agencies.

The Secured Credit Card

But what if you have little or no information on your credit report? How do you build good credit? In many instances, the easiest way to build credit is to obtain a credit card, use it regularly, and make the required payments on time. So how do you obtain a credit card when you have no credit history? One solution is to get a secured credit card. A **secured credit card** is a real credit card—not a prepaid

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credit card or debit card—whose application involves opening a certificate of deposit, the amount of which will be the card's credit limit. A **certificate of deposit** (CD) is a promissory note whereby a bank promises to return to the depositor the principal amount deposited with the bank, plus interest, after a stipulated period of time. Certificates of deposit can have terms of less than 1 year to up to 5 years or more and usually have a minimum initial deposit of $500.

Your CD is a security deposit for the credit card, hence the term "secured credit card." You earn interest on your CD, so your deposit will grow over time. The money in the CD account is yours and will remain yours as long as you don't default on your credit card payments. Ideally, at some point before you are ready to start your business, you will be able to trade in your secured credit card for a traditional credit card, thereby regaining access to the funds in the CD account you created when establishing the secured credit card.

Separation of the Entrepreneur From the Business

LO 1.4	Identify what specifically an entrepreneur can do to separate himself from his business.

Assuming you've successfully completed the many steps suggested thus far in this chapter to properly prepare before starting a business, there are some items of general business knowledge you should also learn before starting a business. All involve proper separation of the entrepreneur from his business.

We'll cover legal form of business in detail in Chapter 3, but it's good to know in advance of starting a company that an entrepreneur should strive to avoid being the owner of a **sole proprietorship**—a business owned and operated by an individual for profit—or a general partner of a **partnership**—an association of two or more persons who conduct business as co-owners for profit. It's often difficult to legally distinguish the owner of a sole proprietorship or a general partner in a partnership from his business. If it's difficult to distinguish the entrepreneur, as an individual, from his business, this puts both the entrepreneur and the business at risk. In most instances, forming a **corporation**—a legal entity authorized by state law to act as an artificial person in order to conduct business or engage in certain other activities—or a **limited liability company (LLC)**—a hybrid legal business entity authorized by state law featuring some of the characteristics of both partnerships and corporations—will serve the entrepreneur better than operating as sole proprietor or general partner because forming a corporation or an LLC allows the entrepreneur to more clearly separate himself from his business.

Clear separation of the entrepreneur from his business increases the likelihood that a business's financial issues won't become the entrepreneur's personal financial issues. Similarly, clear separation of the entrepreneur from the business increases the likelihood that an entrepreneur's personal financial issues—or the personal financial issues of one or more of the entrepreneur's partners—won't become the business's financial issues. In other words, the financial issues of one party do not necessarily have to become the financial issues of the other party if the entrepreneur properly separates himself from his business.

Beyond the choice of legal form of business, an entrepreneur should do the following, as applicable, in order to clearly separate himself from his business:

- Pay the business rent or some reasonable remuneration for any significant business assets the entrepreneur uses for personal purposes (e.g., living on an unused floor of a building rented by the business, as in our earlier wine bar example).
- Make sure the use of any business vehicle is more than 50% business use as documented in a daily mileage log that describes the purpose of every mile driven.
- Keep separate bank and debt accounts for personal versus business use.
- Execute a formal operating agreement between the entrepreneur, the partners (if applicable), and the company.

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- Always sign business documents as a representative of the company rather than personally.
- Never personally guarantee loans, contracts, or other activities of the business.

If you can't completely separate yourself from the business right at the very beginning of the business, at least be sure to keep meticulous records that clearly indicate business versus personal transactions. You'll need to do this eventually for accounting and tax purposes anyway. It's not an elegant solution, but if the best you can do at the very beginning of your company's operations is make sure all of the documentation related to the business ends up in one clearly designated box or drawer, you'll thank yourself later.

How to Properly Sign a Business Document

At the very earliest stages of any business you start, the need to separate yourself from your business will likely show up immediately with regard to one very important area: your signature. In order to properly separate yourself from your business, when you sign any document related to the business you have formed, you are no longer "Jane Doe." You are "Jane Doe, President, American XL, LLC" or "Jane Doe, Founder, American XL, LLC."

The distinction is important. Signing your name including your company title and your company's name clearly distinguishes you as signing as a representative of the company as opposed to you signing personally. The difference can be critical if problems arise—and, in business, problems often arise.

The Personal Guarantee

Before you even start your business, you can fall into the trap of failing to separate yourself from the business. A **personal guarantee** occurs when a third party guarantees the financial obligations of another person or a business. Such guarantees can be specific to one obligation or contract, or they can be general in nature. Regarding a personal guarantee, the following are some important items to consider:

- Will you be asked to personally guarantee certain aspects of your business?
  Probably, yes.

- Should you provide personal guarantees related to your business?
  No, not if you can avoid it. Why would you tie your personal financial future to a potentially negative financial situation associated with your business if you can avoid doing so?

- Do you have to provide personal guarantees to get what you want?
  No, not necessarily. Sometimes, you can offer other acceptable assurances in lieu of a personal guarantee. Acceptable alternatives to personal guarantees include providing security deposits, funds to be held in escrow, partial payments, and business assets for use as collateral. If someone requests a personal guarantee, ask them why they're requesting it. There are usually ways a vendor or creditor's concerns can be addressed without resorting to a personal guarantee.

- Can personal guarantees have amount, time, or other limitations?
  Yes, absolutely. If you find yourself in a situation where you absolutely cannot avoid giving a personal guarantee, then at least be sure to limit both the dollar amount and the duration of the guarantee—and also to expressly limit the circumstances or transactions to which the personal guarantee applies.

Note that if a business has no assets or no revenues and is seeking a loan from a typical bank, in lieu of or in addition to asking for a personal guarantee, the bank may ask the entrepreneurs involved to pledge specific personal assets as collateral for the loan. As a practical matter, this practice also compromises the goal of keeping the entrepreneur separate from his business and should, therefore, be avoided if at all possible.

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The Top 10 Legal and Financial Mistakes Entrepreneurs Make

LO 1.5	List the top legal and financial mistakes entrepreneurs make.

Not surprisingly, entrepreneurs can err in a variety of ways. In most instances, the mistakes made by entrepreneurs that most severely damage a business are either legal or financial. Below are the top 10 legal and financial mistakes entrepreneurs make:

1. Failing to operate the business in such a way as to avoid litigation.

As anyone who has ever spent any time in a significant legal battle knows, it's hard to think of a bigger drain of time, energy, and money than suing someone or being sued. It is therefore of paramount importance, when starting and managing a new company, that the entrepreneur makes it his mission to avoid ending up in litigation.

2. Failing to keep current with regard to filing tax returns and paying taxes.

The IRS and the other federal, state, and local entities that have jurisdiction over your business expect to be paid the amounts due to them when those amounts are due. They've heard every excuse imaginable. They aren't interested in yours.

The IRS and other governmental entities have the power to put liens on your assets, seize your assets, cancel your licenses, suspend your permits, penalize you, fine you, and do a multitude of other unsavory things to both you and your business. The colloquialism "Don't mess with the IRS" has been around for a long time for a reason. Ultimately, the government is going to win, and you are going to lose. In order to avoid time-consuming, complicated, and expensive tax problems, a wise entrepreneur always files the required tax returns on time and always pays the taxes due on time. Period.

3. Failing to put critical agreements, terms of doing business, and other important understandings in writing.

All your business's major agreements, especially the operating agreement, should be in writing. Even the most honest and well-intentioned human beings can genuinely forget or misremember what has been communicated only verbally. Putting the details of any important agreement into a written document to be signed by all parties concerned gives everyone a chance to reflect upon what's being agreed to and make sure all important issues are fully fleshed out and considered.

Often, the founders of a company will bring technology and **intellectual property** (intangible property created from human intellect, often evidenced by copyrights, trademarks, or patents)—or other assets they have developed or purchased—with them as they join the new company. After the company is formed, who owns these assets? In order to avoid future misunderstandings, the ownership of such assets, and any consideration a founder has received with regard to the contribution of such assets to the start-up, should be fully documented—ideally in an operating agreement.

Good operating agreements are available online at reasonable prices, or for free, from websites such as ilrg.com (multi-member LLCs) and eforms.com (single-member LLCs). Note that even if a founder is a solo entrepreneur, he should still complete an operating agreement between himself and his company in order to clearly legally separate himself from his business.

Beyond operating agreements and other types of written agreements, it should go without saying that the basic terms of anyone's employment should be put in writing.

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4. Allowing oneself to be hurried into signing a written agreement.

Too often, in the rush to make a business grow, entrepreneurs sign whatever is put in front of them, especially if it comes from someone they think they can trust. Keep in mind that whoever drafted a legal document took a lot of time to prepare that document. It makes sense that you should take a lot of time to review the document and make sure it reflects what has been verbally agreed upon before you sign it.

Could taking time to read the document completely result in an awkward situation? Yes. If you find that notion disturbing, request to take the document home for the evening for a thorough review so you can bring it back the next day and sign it after you're fully informed. Doing so could prevent you from agreeing to something that is not in your best interest. Entrepreneur in Action 1.1 at the beginning of this chapter presented an entrepreneur's effort to read a document completely resulting in an awkward situation. Let's now see how our entrepreneur, Leigh, ultimately managed that situation.

Resolution of Entrepreneur in Action 1.1: Leigh Dawson's CoffeeCo Contract Conundrum

When we left Leigh, she was feeling uncomfortable about making Steve, from whom she buying a business using owner-financing, sit and wait while she read the entire purchase/sale agreement Steve's attorney had prepared for her. Leigh was feeling like a rookie businessperson who was being unreasonable and wasting Steve's time.

Despite the awkwardness she was feeling, Leigh continued to review every detail of the purchase/sale agreement. Then, Leigh found it. Of course, it must be an accidental error, she thought. The agreement said Leigh would be paying 21% interest on the unpaid balance associated with the company purchase, not the agreed upon 5%. Leigh continued to read on to the end of the agreement. The early repayment option she had requested was not included in the agreement. Leigh looked up to see Steve staring at her. There was a challenge in his eyes. The look on his face indicated that the anomalies in the agreement were not a mistake. Leigh started to speak, faltered, and then said, "I have a feeling I won't be buying your company today, will I?" "Not for 5% financing you won't," said Steve, as he snatched the agreement out of her hands, grabbed Leigh's unfinished coffee from the table, and stomped out of the conference room, slamming the door behind him.

As Leigh exited the building, still feeling quite ill at ease, she struggled to absorb not only the depth of Steve's dishonesty, but also the severity of the financial consequences that would have befallen her if she hadn't taken the time to read every single word of the agreement Steve's attorney had prepared for her signature.

5. Not planning for disagreements between founders and changes in founders' circumstances.

According to an article on the Bloomberg website, approximately 50% of all marriages end in divorce.[8] The "divorce rate" among entrepreneurial business partners is probably much higher. You should anticipate that you and your cofounders will have disputes and, as such, have an agreed-upon procedure for resolving such disputes. You should also have an agreed-upon mechanism so a partner can exit the business, if necessary.

Business partners get sick. They become disabled. They die. Sometimes, they simply lose interest in participating in a business. How circumstances like these and others will be managed should be outlined in a formal operating agreement.

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6. Not putting clear payment terms in place for customers.

This is a common mistake for new entrepreneurs. So excited to make those first few sales, the entrepreneur doesn't clearly indicate to the customer when he expects to be paid for what he just sold. It's hard to force payment when a deadline for payment has not been established. Many are the entrepreneurs who never got paid for their first sale because they neglected to establish firm payment terms, including a deadline for payment and specified consequences for late payment.

7. Not adequately identifying, avoiding, reducing, or insuring against the risks that can destroy a business.

A wise entrepreneur is always trying to reduce risk. **Risk management** involves an individual planning for both his business's assets and his personal assets in such a manner as to reduce uncertainty and risk. Common approaches to risk management include:

- risk avoidance
- risk reduction
- risk transfer
- risk assumption

Risk avoidance is characterized by the avoidance of any hazard that exposes a business or an individual to risk. An example of risk avoidance would be instituting a "Cash Only" sales policy at one's business. A business owner does not have to worry about a check bouncing or a credit card **chargeback**—when a customer uses a credit card to buy something and then cancels the transaction—if he does not accept checks or credit cards. Similarly, a business owner does not have to worry about late or unpaid accounts receivable if he does not offer customers the opportunity to make purchases using credit or trade credit. (**Accounts receivable** refers to the amounts customers owe a company related to their purchases from that company utilizing the credit or trade credit offered by that company. **Trade credit** is a business-to-business arrangement by which the customer business can purchase items from the supplier business on account—paying no cash at the time of purchase but instead paying for the items at a later date.)

Risk reduction involves engaging in behaviors and programs specifically designed to reduce risk. An example of risk reduction behavior would be installing a sprinkler system and a security system at one's business facility. While by no means guaranteeing that neither will happen, a sprinkler system and a security system do significantly reduce the likelihood that one's business will be destroyed by fire or be burglarized.

Risk transfer involves proactively transferring risk to another party. An example of risk transfer would be selling a business's accounts receivable to a factor. A **factor** is a third party who, for a fee that is usually equivalent in amount to 1% to 5% of the total accounts receivable sold by the business owner, provides the business owner with immediate cash for the accounts receivable and then goes about collecting the accounts receivable themselves.[9,10] **Factoring with recourse** involves factoring accounts receivable such that the risk of the accounts receivable being uncollectible remains with the seller and typically involves the factor receiving either some sort of blanket security interest in all of a business's assets or some sort of business owner personal guarantee. **Factoring without recourse** involves factoring accounts receivable such that the risk of the accounts receivable being uncollectible is transferred from the seller to the factor. In this instance, if an account receivable cannot be collected, the factor does not have to be reimbursed as they would have to be if the factoring was with recourse. Entrepreneur in Action 1.2 highlights a situation where a business owner decides he wants to factor his company's accounts receivable in order to finance moving his company forward. The example also demonstrates how seeking an alternative to granting a personal guarantee can often work out well for an entrepreneur.

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Entrepreneur in Action 1.2: Enrique Perez's Personal Guarantee Predicament

Enrique Perez was preparing for a meeting with his bank, First Fourth Bank, about his company, Practical Lighting, LLC. Enrique and his business partners had spent the last 8 months developing a new lamp, called the LumensPro, which didn't need to be plugged into an electrical outlet but instead provided its light via an extremely powerful, long-life battery. It was almost time to launch the new product, the actual manufacturing of which was to be outsourced to Edwards Manufacturing, Inc. Enrique and his partners planned to sell the new product to individual homeowners and renters by means of social media marketing and Practical Lighting's website. Enrique and his partners expected the product to be a blockbuster. One of the last items that had to be arranged before the new product launch was the financing for a down payment of $100,000 to Edwards Manufacturing related to Practical Lighting's first order of 5,000 units of the LumensPro. For this, Enrique needed the cooperation of his bank. As a result, Enrique had arranged a meeting with Jason Ajuga, the manager of First Fourth bank.

Upon arriving in Jason's office at the bank, and after handing Jason his company's most recent financial statements, Enrique explained to Jason the nature of the financing he was seeking. Enrique was surprised to see Jason start shaking his head slowly in a negative fashion. Jason explained that banks typically don't make loans to support the purchase of inventory, especially when that inventory is an unproven, new product, but Jason then said that he was willing to explore options with Enrique. Jason asked what kind of collateral Enrique's business could offer to support the loan. Enrique reminded Jason that Practical Lighting was a firm that designed, marketed, and sold products, but did not manufacture products. As a result, Practical Lighting owned few fixed assets, and the fixed assets the business did own didn't approach being high enough in value to collateralize the $100,000 loan Enrique was seeking. Jason said the situation Enrique currently found himself in was usually resolved by the owners of a company personally guaranteeing the needed loan.

There was an awkward silence as Enrique pondered what was being requested of him and his partners. Enrique's lawyer had told him when he started Practical Lighting to try to avoid personally guaranteeing anything associated with the business. Enrique looked at Jason and said he wasn't comfortable giving a personal guarantee and explained why. Jason said he understood, but then he added, "This is how the possibility of loan default is usually managed when there is insufficient collateral." Enrique asked if there wasn't possibly some other way to rectify the situation. Jason considered this, then studied Practical Lighting's most recent balance sheet for a moment, and finally said, "While First Fourth bank isn't in the business of buying a business's accounts receivable, certain companies, commonly called factors, are." Jason suggested that Enrique find a factor that would acquire his company's accounts receivable without recourse and then use the funds to pay the $100,000 down payment to his manufacturer. Financing the required down payment in this way would eliminate the need for Enrique and his partners to personally guarantee a bank loan or any other type of financial arrangement.

Enrique thanked Jason for suggesting he use a factor. Enrique felt strongly that he would much rather factor his business's accounts receivable than have to worry about the potential consequences associated with personally guaranteeing a loan to his business.

Other common examples of risk transfer include outsourcing a process or project to a third party—such that the third party bears responsibility for any losses or unplanned expenses associated with the process or project—and paying for insurance policies that reimburse one for losses associated with one's personal or business assets. The key elements of risk transfer via the purchase of insurance will be explained in Chapter 14.

Risk assumption occurs when one proactively assumes risk because one believes that the loss or cost one is likely to incur by assuming that risk is less than the loss or cost associated with risk avoidance, risk reduction, or risk transfer. For example, many businesses accept checks and credit cards from their customers—or offer credit or trade credit to their customers—because they believe the cost of the occasional bad check, credit card charge-back, or bad account receivable is more than offset by the increased level of sales they enjoy by assuming the risk of possible customer nonpayment. As a further example, some

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businesses self-insure their employees' medical coverage because they believe that the amount they will pay out of pocket to settle their employees' medical bills will be less than the cost of the medical insurance premiums they would have to pay in order for an insurance company to settle those medical bills.

8. Expecting too much—or too little—in return for sweat equity.

Maybe the concept you and your founding team are pursuing was your idea. Maybe you did most of the research to complete the feasibility analysis. Perhaps you've spent long hours fabricating the working prototype for your fledgling product company. Or perhaps you've instead spent long hours working out the operating processes for your fledgling service company. You've been told by your family and friends not to start a business, and you've done it anyway. You've been told by naysayers that you're going to fail, and you keep going anyway. The mental and physical stresses you've endured are many. Now that you've perfected your product or service, you need funding to grow your fledgling company. It'd be great if you had the money yourself, but you don't.

Remember that equity is dear and shouldn't be given away without careful consideration, because once you give away a portion of the ownership of your company, it's unlikely you'll ever get it back. However, remember also that those who can afford to fund your company generally have many promising start-ups from which to choose. A wise entrepreneur thinks far into the future and attempts to determine in advance what he would value highly enough that it would be worth giving up equity to obtain it.

9. Processing payroll internally.

For those of you who aren't certified public accountants (CPAs) or accountants, you may think doing payroll sounds complicated. You're right. Outsource the payroll function. Outsourcing payroll is actually quite inexpensive and one very wise step to take to help ensure you don't walk into the mine field of trouble described in item 2 of this list.

You may think, because you're a CPA or an accountant, you should do the payroll for your own business. Think again. Of all the things you should be spending your time on, entrepreneur, this is absolutely last on the list. Your time is valuable. Outsource the payroll function.

10. Using vague or ambiguous terms in written agreements.

Vague terms create confusion. Classic examples of vague terms are the words *many, right, nice*, and *good*. Depending upon the context in which they're used, your interpretation of the meaning of these words might be entirely different from the interpretation of their meaning by your business partners or others. The whole point of a written agreement is to clarify issues and create understanding, not confusion. Be sure to replace the vague words in any written agreement with specific words that have clear meanings to everyone involved.

Ambiguous references, by definition, can have more than one meaning. Classic instances of ambiguity are often caused by the inappropriate use of pronouns. For example, consider the following statement: "Ron Smith is responsible for in-processing all deliveries and will assist Karl Jones with unpacking and stacking all such deliveries. His signature of approval will be required on all packing lists." Whose signature of approval will be required on all packing lists, Ron's or Karl's? Note that rewriting entire sentences, not just trading out a word or two, may be necessary in order to clarify ambiguous references.

Summary

LO 1.1 Describe how entrepreneurial finance is different from traditional business finance.

Beyond the fact that one discipline focuses on starting a new business and the other focuses on managing an existing business, it is the depth of the relationship between the entrepreneur's personal finances and the finances of the entity he creates that makes

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entrepreneurial finance fundamentally different from traditional business finance. In other words, the topic of entrepreneurial finance recognizes that, oftentimes, entrepreneurs make decisions for the businesses they've founded with their personal financial goals—and other personal goals—clearly in mind.

LO 1.2 Explain how a business plan is different from a feasibility analysis and why an entrepreneur should always do a feasibility analysis before starting a business.

A business plan is a comprehensive document that focuses on how to build a company, prepared by—and for the benefit of—the entrepreneurs involved, but written with an outside audience of potential investors, lenders, strategic partners, or major talent targets in mind. A feasibility analysis is a more narrowly focused document than a business plan as it concentrates on assessing the likelihood of economic success of a business, primarily for the benefit of the entrepreneurs contemplating starting that business. A feasibility analysis is critically important because it proves or disproves a new concept's viability in the marketplace (i.e., if enough customers will buy the product or service to make a business based on the concept viable). If there aren't enough expected customers to make the business concept viable, the answer regarding whether or not to start the business is clear.

LO 1.3 Discuss how an entrepreneur can financially sustain himself during the start-up phase of his business.

Generally, you can sustain yourself personally during the start-up phase of your business utilizing funds you already have, income you earn on an ongoing basis from a job or another existing business you may own, strategic expense minimization, or funds you borrow.

LO 1.4 Identify what specifically an entrepreneur can do to separate himself from his business.

Clear separation of the entrepreneur from the business increases the likelihood that a business's financial issues won't become the entrepreneur's personal financial issues. Similarly, clear separation of the entrepreneur from the business increases the likelihood that an entrepreneur's personal financial issues—or the personal financial issues of one or more of the entrepreneur's partners—won't become the business's financial issues. In other words, the financial issues of one party do not necessarily have to become the financial issues of the other party if the entrepreneur properly separates himself from his business.

In order to properly separate himself from his business, the entrepreneur should consider setting up his business as either a corporation or an LLC; pay the business rent or some reasonable remuneration for any significant business assets the entrepreneur uses for personal purposes; make sure the use of any business vehicle is more than 50% business use as documented in a daily mileage log; keep separate bank and debt accounts for personal versus business use; execute a formal operating agreement between the entrepreneur, the partners (if applicable), and the company; always sign business documents as a representative of the company rather than personally; and never personally guarantee loans, contracts, or other activities of the business.

LO 1.5 List the top legal and financial mistakes entrepreneurs make.

The top 10 legal and financial mistakes entrepreneurs make include failing to operate the business in such a way as to avoid litigation; failing to keep current with regard to filing tax returns and paying taxes; failing to put critical agreements, terms of doing business, and other important understandings in writing; allowing oneself to be hurried into signing a written agreement; not planning for disagreements between founders and changes in founders' circumstances; not putting clear payment terms in place for customers; not adequately identifying, avoiding, reducing, or insuring against the risks that can destroy a business; expecting too much—or too little—in return for sweat equity; processing payroll internally; and using vague or ambiguous terms in written agreements.

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Review and Discussion Questions

1. How is entrepreneurial finance different from traditional business finance?
2. What should a nascent entrepreneur do to prepare for starting a new business?
3. What is a business plan and how is it different from a feasibility analysis? Why should an entrepreneur always do a feasibility analysis before starting a business?
4. How can an entrepreneur financially sustain himself during the start-up phase of a new business?
5. Why is it a problem for an entrepreneur—or one or more of his business partners—to have a low credit score? What can an individual do to improve a bad credit score?
6. What can an entrepreneur do to separate himself from his business? Why is it wise for an entrepreneur to separate himself from his business?

Exercises

1. Appropriate preparation before you start a new venture, perhaps before you even have an idea for a new venture, will serve you well as an entrepreneur. Write a two- to three-page paper detailing the following about your favorite entrepreneur: (1) the person's company and the significant products or services it offers, (2) the inspiration for the entrepreneur starting the company (i.e., the problem he or she wanted to solve), (3) the preparation performed and education completed by the entrepreneur prior to starting the company, (4) the major reasons for the entrepreneur's success, and (5) anything else you feel is important about the entrepreneur and his or her company.
2. Before starting a business, an entrepreneur should have established a large network both within and outside of the industry in which he intends to start the business. One of the best ways for an entrepreneur to make, keep in contact with, and keep track of business connections is via LinkedIn (linkedin.com). Review the LinkedIn profiles of a famous entrepreneur, an entrepreneur based in your hometown, and the head of a major corporation. Write two to three paragraphs describing, comparing, and contrasting the profiles. Indicate whose profile is the best, in your opinion, and explain why.
3. An entrepreneur increases his chances for entrepreneurial success if he's not worried about how he's going to pay his personal bills during his new venture's start-up phase. Write four to five paragraphs detailing how three entrepreneurs—each operating in a different industry—financially supported themselves while working to make their businesses profitable. What similarities and differences do you note in the three entrepreneurs' approaches? Indicate which of the three entrepreneurs' personal financial choices you would most likely emulate if you were to start a company and explain why.
4. It is important to check your credit report regularly because (1) the report could include inaccurate information, (2) some of your credit accounts could be missing from the report, and (3) information that doesn't belong to you could be included on your report. Go to annualcreditreport.com and request a free copy of your credit report. Is all of the information in the report correct? Is any important information missing? Is there any information that surprised you? Without disclosing any personal details, write two to three paragraphs describing the process of obtaining the free credit report and any surprises, inaccuracies, or items of interest you may have discovered along the way.
5. One of the top legal and financial mistakes entrepreneurs make is failing to keep current with regard to filing tax returns and paying taxes. That said, how do you keep current with regard to tax law, entrepreneurial finance, and related topics? One great way is to read a magazine

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that regularly addresses these topics. Search “finance” at inc.com. Read a finance article of your choice. Write two to three paragraphs describing the concepts included in the article and especially highlighting anything you learned as a result of reading the article. Be sure to include the title, date, and web address of the article you read.

6. All of your business’s major agreements—especially the operating agreement—should be in writing. Read the member-managed operating agreement for your state at ilrg.com. You can read the agreement without paying for it or downloading it. Next, write two to three paragraphs detailing what items included in the agreement are items you likely wouldn’t have addressed with potential business partners without such a document prompting you to do so. What items, if any, do you think should be added to the agreement?

Key Terms

accounts receivable
business model
business plan
certificate of deposit (CD)
charge-back
corporation
credit report
credit score
entrepreneurial finance
factor
factoring with recourse
factoring without recourse
feasibility analysis
intellectual property
limited liability company (LLC)
partnership
pass-through entity
personal guarantee
pro forma financial statements
risk assumption
risk avoidance
risk management
risk reduction
risk transfer
secured credit card
sole proprietorship
strategic expense minimization
trade credit
working capital

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Chapter 2

Sources of Funding

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Learning Objectives

After completing this chapter, you should be able to:

2.1 Identify the common sources of funding available to a typical U.S. start-up venture.

2.2 Explain the nature of the typical investment in a U.S. start-up venture by angel investors, venture capital funds, Community Development Financial Institutions (CDFIs), and providers of grants.

2.3 Describe the differences between—and the challenges associated with—donation-based, reward-based, lending-based, and equity-based crowdfunding.

2.4 Identify the sources of debt financing available to a U.S. start-up venture.

2.5 Discuss the fundamental differences between—and the regulatory considerations associated with—utilizing an initial public offering (IPO), Regulation A, Regulation D, or Regulation Crowdfunding to procure funding for a young venture.

Entrepreneur in Action 2.1: Carrie Paxton's Business Funding Puzzle

It was December 2025, and CFO Carrie Paxton needed cash for her business, MedPet, Inc. MedPet was developing a new app that would allow users to monitor the vital signs of their cat or dog via a small chip implanted inside one of the animal's ears. Recent veterinary research had clearly concluded that, since pets generally can't effectively communicate how they are feeling, the health issues of pets often aren't recognized until the issues become acute—meaning the health issues develop to the point of either becoming complicated to address or causing severe pain to the pet. The MedPet application was designed to immediately alert a pet owner when their pet's vital signs suggest the pet is either ill or in pain—so the pet owner can take action before the underlying health issue or injury becomes acute.

After clearing all the applicable regulatory hurdles, Carrie and her partners had successfully developed and field-tested a prototype of both the app and the chip. Now they were working on a final design that was both commercially viable and able to be inexpensively mass produced. The final design process was going well except for one thing: the company was quickly running out of cash. The company needed a cash infusion to be used not only to complete the final design of the app and chip but also to launch the marketing campaign needed to make potential customers aware of the new product.

Carrie and her business partners had agreed they didn't want to borrow to get the $1 million the company needed. One of Carrie's partners, Darnell, had told Carrie he thought MedPet should pursue equity crowdfunding to raise the $1 million because the MedPet product had such huge commercial appeal that it should be easy to execute a successful crowdfunding

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campaign. Carrie was unsure. She had read news articles about the rules promulgated by the SEC related to equity crowdfunding, and some of what she had read had made her nervous. Another of Carrie's partners, Jamal, had told Carrie he felt confident MedPet should pursue venture capital investment to raise the cash the company needed because MedPet's new technology held enormous market potential, and this should be attractive to venture capitalists. Carrie was also unsure about this option. She had heard from some of her entrepreneur friends that venture capitalists often want to exert significant control over the companies they invest in—and Carrie wasn't sure she wanted to compromise her and her partners' ability to make decisions for MedPet. Carrie's other partner, Kirstin, had told Carrie she believed MedPet should pursue angel investment to raise the cash the company needed. Carrie thought Kirstin's idea had merit, but Carrie also realized she had no understanding of the processes or legalities associated with obtaining an angel investment.

Carrie had slowly realized that she really wasn't sure what was the best source of the $1 million MedPet needed—or how to move forward in any meaningful way to get the money. Carrie felt paralyzed by the complexity of the decision before her.

As you read this chapter, think about the situation Carrie finds herself in and how you might react to it. We'll return to Carrie's dilemma later in this chapter.

Common Sources of Funding Available to a Typical U.S. Start-up Venture

LO 2.1	Identify the common sources of funding available to a typical U.S. start-up venture.

Before launching into a discussion of what type of entity typically receives what type of funding, it is important to note that there are significant differences between a typical U.S. small business and a more broad-based entrepreneurial venture. A small business tends to come up with ideas that solve local problems. It helps keep money and jobs in the local community. A more broad-based entrepreneurial venture tends to come up with ideas that solve national or world problems. It generates revenues and creates jobs wherever it decides to locate. A small business tends to be more limited in scope and involves innovations that, while important, are not necessarily disruptive. An entrepreneurial venture tends to pursue larger scope, more disruptive ideas that involve a higher degree of risk. A small business owner tends to enjoy operating her business day to day, and while she might desire to grow the business geographically or otherwise, that growth tends to be slow and sure, rather than exponential. The founder of an entrepreneurial venture often enlists others to manage the day-to-day operations of the business while she functions more as a rainmaker and an implementer of sweeping change. Small businesses are the backbone of the U.S. economy. Entrepreneurial ventures propel the U.S. economy forward.

The typical U.S. entrepreneurial venture usually has the opportunity to pursue and obtain funding from any or all of the sources about to be discussed in this chapter. The funding sources available to the typical U.S. small business are more limited. U.S. small businesses generally do not have the market potential to attract angel or venture capital investment, and they also generally do not have the internet appeal to successfully pursue crowdfunding. Grant capital is largely reserved for nonprofit organizations, and most banks are too risk averse to loan money to a start-up venture of any type.

So, what sources of start-up funding are available to U.S. small businesses? Usually, a small business begins by utilizing funds from the founders themselves and funds from their friends and families. As the business builds **traction**—evidence, such as sales or another form of positive customer response, that a product or service is being adopted at such a rate that both the business model and the business's potential for sustainable growth appear to be validated—dependent upon the type of business, loans sponsored by the Small Business Administration, (SBA), a Community Development Financial

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Institution (CDFI), or a Capital Access Program (CAP) often become the next source of funding for the typical U.S. small business. Later, as the business matures, some types of traditional bank financing usually become an option.

Before looking to any outside source for funding, however, in order to minimize the amount of capital needed to start a business and operate it during its early stages, an entrepreneur should bootstrap her business to the extent reasonably possible. **Bootstrapping** involves borrowing noncash assets, bartering for noncash assets and services, and utilizing strategic negotiation tactics in order to avoid, delay, or minimize the outlay of cash. Bootstrapping involves seeking what you can "get for free" or purchase "used." At its most basic level, bootstrapping involves embracing the entrepreneurial mindset in order to get a business through its start-up and early operation phases until more traditional means of financing the young venture become available. The concept of bootstrapping will be explored in detail in Chapter 9.

While it does help minimize the amount of capital a business needs, bootstrapping cannot completely eliminate a business's need for capital. There are two major categories of capital generally available to the typical for-profit business: equity capital and debt capital. **Equity capital** is capital acquired by a business as a result of selling some form of ownership of that business. **Debt capital** is capital acquired by a business with the understanding that the capital will have to be repaid by the business, usually within a defined time period and usually with interest. Other sources of capital for a start-up that involve neither equity nor debt capital include donation- and reward-based crowdfunding and grants. **Donation-based crowdfunding** is the accumulation of small amounts of capital from a large number of individuals via a campaign on the internet, such individuals expecting nothing in return. **Reward-based crowdfunding** is the accumulation of small amounts of capital from a large number of individuals via a campaign on the internet, such individuals expecting very little in return other than a news update, a small token gift, or a promised product or service, usually of nominal value. **Grants** are monies provided to an individual or an entity that do not have to be repaid to the provider of the monies (the grantor) as long as the receiver of the monies (the grantee) provides the goods or performs the services for which the grant was approved.

Considering that there are so many sources of funding available to a start-up—all with different implications for both the founders of a new venture and the new venture itself—it is helpful to categorize sources of capital as follows:

- providers of equity or debt capital, such as:
  - the founders themselves—individuals who generally provide a venture with its very first seed capital, either from their personal savings or by taking on personal debt (**seed capital** is the funding required to get a business started and actively pursuing full-scale operations)
  - friends, family, and "fools"—individuals who usually know the founders very well and provide them with secondary seed capital, usually because they believe in either the founders or the business concept the founders are pursuing
  - **angel investors** (commonly referred to as angels)—individuals, usually successful or retired entrepreneurs or businesspeople, who provide follow-up investment and free mentoring to start-up businesses
  - **venture capital funds**—monies typically used to invest in young, market-driven companies with very large upside potential accumulated by:
    - **a.** private **venture capital firms** (firms typically set up as limited partnerships that gather large sums of money from investors and deploy these monies by investing in the start-ups that survive the venture capital firm's vetting process)
    - **b.** corporate venture capital funds
    - **c.** **small business investment companies** (SBICs) (firms similar to venture capital firms that are licensed and regulated by the Small Business Administration)
  - community development financial institutions (CDFIs)—organizations that aim to expand economic opportunity in low-income communities by providing access to financing for businesses that support local economic development activity

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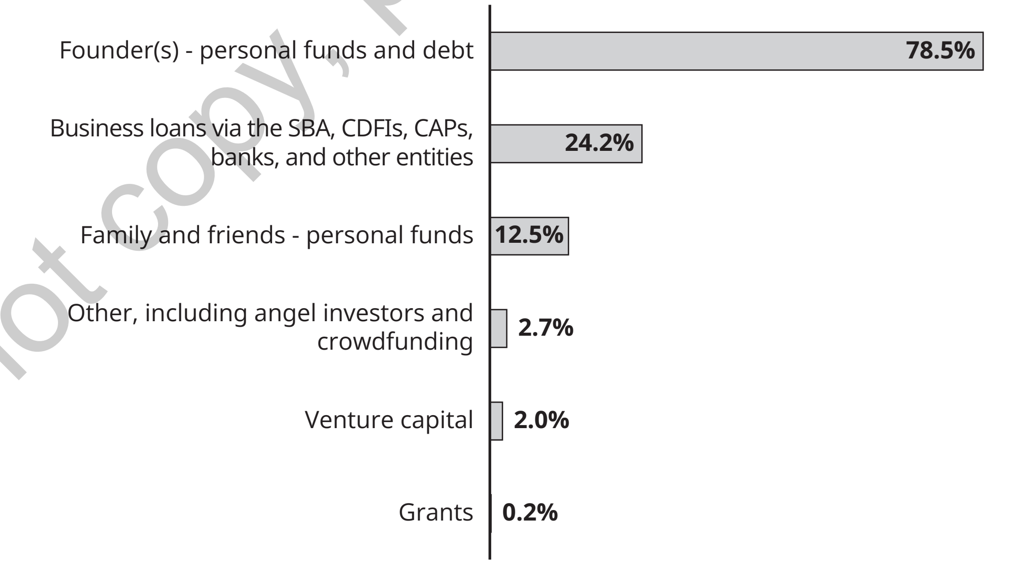
- providers of equity capital only, such as participants in equity crowdfunding (**equity crowdfunding** is the accumulation of small amounts of capital from a large number of individuals via a campaign on the internet, such individuals receiving an ownership interest in the company in which they invest)
- providers of debt capital only, such as:
  - banks and a variety of other lenders, including lenders who administer or participate in government-supported loan programs
  - participants in lending-based crowdfunding (**lending-based crowdfunding**—also called debt crowdfunding and crowd lending—is the accumulation of small amounts of capital from a large number of individuals via a campaign on the internet, such individuals expecting to be repaid by the company, with interest)
- providers of capital that is neither equity capital nor debt capital:
  - grant-issuing governmental agencies and public and private trusts and foundations
  - participants in donation-based crowdfunding (examples of donation-based crowdfunding portals include GoFundMe and Mightycause) or reward-based crowdfunding (examples of reward-based crowdfunding portals include Kickstarter and Indiegogo)[1,2]

Figure 2.1 is an analysis of the sources of funding U.S. for-profit businesses with employees use to finance their start-up operations and it indicates that, overall, the typical founder contributed a significant amount of the funding for her start-up business from her or her family's personal funds. That said, many start-ups do pursue and successfully obtain at least one outside source of funding. What type of funding—and from what source—depends very much upon the entrepreneur and the nature of her business.

Figure 2.1 ▪ Sources of funding U.S. for-profit businesses with employees use to finance their start-up operations.



Source: Adapted from: "Access to Capital for Entrepreneurs: Removing Barriers, 2023 Update," Kauffman Foundation, https://www.kauffman.org/wp-content/uploads/2023/06/Access-to-Capital-for-Entrepreneurs-Report-2-June-2023.pdf#contact-form-89814, accessed 9/15/23.

Note: The percentages in Figure 2.1 do not add up to 100% because many start-up businesses use more than one source of funding.

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Important items to note when considering which sources of funding are best for your start-up include the following:

- Once you give away or sell any ownership (equity) of your company, it is very unlikely you will ever get it back.
- Investors in start-ups take on a lot of risk and expect a healthy profit on their investment in return. They also expect to eventually be repaid or provided with a means to exit their investment.
- Debt needs to be repaid, and there are limits to the amount of debt any company can obtain and support.

Angel and Venture Capital Investment, CDFIs, and Grants

LO 2.2	Explain the nature of the typical investment in a U.S. start-up venture by angel investors, venture capital funds, CDFIs, and providers of grants.

Angel Investors

The term "angel investor" originated on Broadway, where it was used to describe the individuals who provided the financing for theatrical productions.[3] Today, angel investors are wealthy individuals—usually making $200,000 or more in income every year or maintaining a net worth of over $1 million, excluding their primary residence—who invest either debt or equity capital—or some combination of both—in start-ups and early-stage companies. In addition to providing funding, because angels are usually successful or retired entrepreneurs or businesspeople, angels also often provide free mentoring to the companies in which they invest. The Center for Venture Research estimates there were 363,460 active angel investors in the United States in 2021, up significantly from the 124,900 active angels reported in 2011.[4] These angels invested in 69,000 start-ups in 2021, the primary goal of such investment being the desire to make a profit, with a typical secondary goal of helping other entrepreneurs succeed.[5]

Like all investments in entrepreneurial start-ups, the investments made by angels are considered high risk. As a result, investments in entrepreneurial start-ups normally don't represent more than 10% of the total investment portfolio of any given angel.[6]

An angel investor typically looks to invest in a young business with these characteristics:

- Its product, service, or business model has a clear competitive advantage.
- It is pursuing a large or fast-growing market.
- It has a passionate founding team that possesses the skills necessary to successfully deliver the product or service and execute the business model.
- It could potentially return the angel 10 times her investment in 5 years.[7]

According to the Angel Capital Association, the average angel investment in a start-up is $52,000.[8] Recent research by the Kauffman Foundation and Nesta indicates the following additional details about angel investments:

- On any one investment, an angel is more likely than not to lose some or all of her investment.
- Ninety percent of all cash returns are produced by 10% of an angel's investments.

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- Over a period of approximately 4 years, the typical U.S. angel investor makes an average 2.5x return on all of her angel investments combined (i.e., an investment of $100,000 would return $250,000).[9] This equates to an approximate 25% annual return.

An **accredited investor** is an individual who made over $200,000 in income in each of the prior 2 years, and reasonably expects the same for the current year—or who has a net worth greater than $1 million, excluding their primary residence.[10] In addition, certain professional criteria, such as holding a **Series 7 license** (a Series 7 license is a general securities representative license that qualifies the holder to participate in the solicitation, purchase, and/or sale of all securities products, including corporate securities, municipal fund securities, options, direct participation programs, investment company products, and variable contracts), may qualify an individual to be treated as an accredited investor.[11] Most angel investors are accredited investors. An increasing number of accredited angel investors are organizing themselves into angel groups or angel networks in order to pool their investment capital, share research, and find sources of experienced advice for their portfolio companies. The Angel Capital Association (ACA) is a collective of 15,000+ accredited angel investors that makeup the largest angel professional development organization in the world. The organization's website (www.angelcapitalassociation.org) includes a directory of angel organizations that have an affiliation with the ACA so the entrepreneur can learn more about the groups, including their investment preferences and processes. The entrepreneur should note that there may be fees or other costs associated with presenting to the investor groups that are listed in the ACA's directory or otherwise affiliated with the ACA.[12]

In addition, many websites exist that are designed to provide entrepreneurs with a standardized platform with which to efficiently approach angels for new venture funding. In 2022, the most popular websites used to secure angel investments were AngelList, SeedInvest, and FundersClub.[13] The entrepreneur should note that there are often fees and other costs associated with presenting to angels and angel groups using these and similar platforms.[14]

Also, the entrepreneur should remember that, when partnering with an angel, it is likely to be a fairly long-term relationship. With that in mind, in order to find an angel investor, the entrepreneur should consider talking with friends and family, inquiring of local business owners, and reaching out to any local angel investor organizations before resorting to a website. When it comes to angel investors, because of the desired mentoring and networking that can be provided by angels, local is often best.

Venture Capital

Private venture capital firms, SBICs, and certain large corporations provide capital sourced from designated venture capital funds to select start-up businesses. Venture capital is typically provided to an early-stage, high-potential, or high-growth start-up company, usually in one of the technology industries. While it can involve a component of debt, a venture capital investment is typically an equity investment that has the following attributes:

- It occurs as the first sophisticated round of investment capital (often referred to as a **Series A** round of investment) to fund a young entity's growth after seed capital has already been provided.
- It is made in the interest of generating returns similar to those desired by angel investors (i.e., 10 times the investment returned in 5 years).
- It generates a return through an eventual realization event such as the sale of the company or an initial public offering. A **public offering** is an issue of securities offered for sale to the public by a company or other entity. An **initial public offering (IPO)** is a very highly regulated and managed first sale of most or all of the stock of a previously private company—or mostly private company—to the general public. An IPO is generally very expensive to pursue, in part because a successful IPO usually requires the assistance of a team of CPAs and attorneys to meet SEC and other regulatory requirements.

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Because of the high risk that venture capitalists assume by investing in small, early-stage companies, venture capitalists usually ensure that they can exert significant control over these companies, when they deem such control desirable. Venture capitalists deciding to exert control over a young company can oftentimes be quite challenging for the company's founders. This is a reason why, although there were approximately 27,000 venture capital investments made globally in 2022, some founders reject venture capital as a source of funding.[15]

Venture capital firms are different from **private equity firms**. Private equity firms help manage the mature companies of which they usually buy majority control or full control, often over time. Venture capital firms (and angels) invest in young, typically fast-growing companies and rarely pursue majority control.

Corporations as a source of venture capital are relatively new to the entrepreneurial funding landscape. In the late 1990s, certain large corporations started to recognize the opportunities associated with being invested in the young ventures innovating in their industries. As a result, these corporations—corporations such as Cisco, Intel, and Johnson & Johnson—began to establish multimillion dollar venture capital funds for the purpose of investing in such companies. A recent development in the world of corporate venture capital is the creation of what are commonly called "CVCs." CVCs are funds that have a corporation as either the only general partner or the primary limited partner of a unit managed by a traditional venture capital firm.[16] Corporate venture capital is widely viewed as a desirable source of funding because of the vast amount of resources and business savvy the corporate entities who created these funds can potentially bring to the table.[17]

According to Silicon Valley Bank, the number of corporate venture capital funds grew approximately 650% between 2010 and 2020.[18] Worldwide, there are now more than 4,000 corporate venture capital funds actively making investments.[19] During the first half of 2021, these funds inked more than 2,000 deals worth $79 billion.[20] Deals involving corporate venture capital now account for 19% of all venture capital investments made globally—up from 15% in 2021.[21] Currently, some of the top CVC firms in the world, in terms of investments made, include Google Ventures, Intel Capital and Qualcomm Ventures.[22]

Although the U.S. Small Business Administration (SBA) does not itself invest in small businesses, it does license and regulate privately owned and managed investment firms called small business investment companies (SBICs). SBICs search for and invest in promising U.S. small businesses in need of debt or equity financing. SBICs are similar to venture capital firms in terms of how they operate and in their pursuit of high returns.[23] Since its launch in 1958, the SBA's SBIC program has deployed over $67 billion in capital, investing in over 166,000 growth stage businesses, including companies such as Apple, Tesla, FedEx and Whole Foods.[24] The program is currently authorized to invest up to $4 billion per year.[25] You can learn more about SBICs at sba.gov.

Beyond the benefits associated with having firsthand knowledge of some of the latest innovations about to hit the market, why do private venture capital firms, SBICs, and certain large corporations invest in high-risk start-up businesses? According to the National Bureau of Economic Research, the average annual return a U.S. venture capital fund receives on all of its venture capital investments combined is 25%—similar to the results achieved by angel investors.[26]

Community Development Financial Institutions

Community development financial institutions (CDFIs) aim to expand economic opportunity in low-income communities. They generally do this by providing access to financing for businesses that support local economic development activity, especially those businesses that create new local jobs or create—or improve access to—affordable housing. CDFI support is usually in the form of a loan or some type of loan support, but it can also sometimes involve an equity investment or a grant. As illustrated in Figure 2.2, CDFIs come in the form of banks, credit unions, depository institution holding companies, community development loan funds, and community development venture capital funds. There are 1,390 CDFIs nationwide.[27] They exist in every U.S. state, the District of

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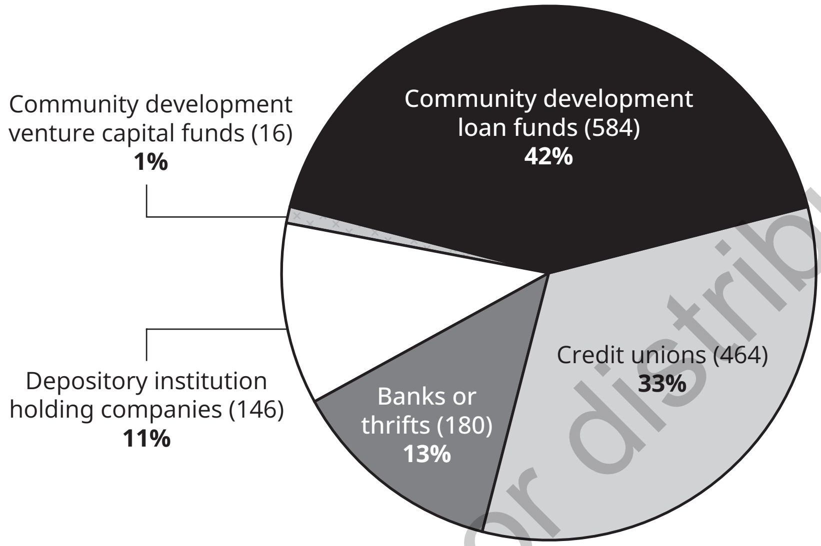
Columbia, and several U.S. territories—and they serve both urban and rural communities.[28,29] The U.S. Treasury Department reviews certified CDFIs annually to ensure their business model meets congressionally-mandated requirements.[30]

Figure 2.2 ▪ Providers of U.S. CDFI funding.



Source: Adapted from: "An Overview of Community Development Financial Institutions," Consumer Compliance Outlook, First Issue, 2022.

CDFIs manage more than $222 billion nationwide, creating jobs, affordable housing, and other opportunities for those in benefiting communities.[31] Financing via a CDFI can make sense when traditional financing from banks or private investors is not an option due to less than perfect credit or because a business generates returns too low to attract angel or venture capital investment. You can find out if there is a CDFI in your community by visiting cdfifund.gov.

Grants

Grants are monies provided to an individual or an entity that do not have to be repaid to the provider of the monies (the grantor) as long as the receiver of the monies (the grantee) provides the goods or performs the services for which the grant was approved. In the United States, grants are most often issued by governmental agencies and a wide range of public and private trusts and foundations.

According to an April 2020 summary analysis created by Candid, a 501(c)(3) nonprofit whose data tools on nonprofits, foundations, and grants are considered by many to be the most comprehensive in the world, in 2018, 119,791 U.S. grant-awarding foundations holding $1.2 trillion in assets awarded $82 billion, primarily to organizations pursuing initiatives in the areas of health and education.[32,33] The median grant amount was $35,000 and the populations primarily served by such grants included economically disadvantaged people and children and youth.[34] For more information about grants issued by U.S. foundations and other nongovernmental grant-awarding entities, check out candid.org.

The federal government generally does not provide grants related to starting or expanding a business. Federal grants are generally only available to nonprofits and educational institutions related to specific areas of pursuit, such as medicine, education, scientific research, and technology development. The SBA does, however, provide limited grants to small businesses pursuing scientific research and development or providing management and technical assistance to eligible small businesses.[35] The SBA also provides grants to states and eligible community organizations to promote entrepreneurship.[36]

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Some industry-specific business grants are available through state and local programs, nonprofit organizations, and other groups.[37] Start your search for government grant funding by visiting grants.gov and sba.gov.

Crowdfunding

LO 2.3	Describe the differences between—and the challenges associated with—donation-based, reward-based, lending-based, and equity-based crowdfunding.

As mentioned earlier in this chapter, donation- and reward-based crowdfunding involve the accumulation of small amounts of capital from a large number of individuals via a campaign on the internet, such individuals expecting nothing in return (donation-based crowdfunding) or very little in return, such as a news update, a small token gift, or a promised product or service, usually of nominal value (reward-based crowdfunding). The beauty of donation- and reward-based crowdfunding is that the entrepreneur receives funding without giving away any ownership or taking on any debt. An additional benefit is that the start-up's "investors" often become its advocates via positive word-of-mouth and promotion on social media. In some cases, the benefit the "investor" receives as a result of reward-based crowdfunding is the start-up's product or service, which means that—via its crowdfunding campaign—the start-up is essentially selling its product or service. Such sales can provide **proof of concept**—evidence that a business concept is feasible. Proof of concept makes obtaining follow-up financing via more traditional sources of funding more possible for the start-up.

As also mentioned earlier in this chapter, lending-based crowdfunding is the accumulation of small amounts of capital from a large number of individuals via a campaign on the internet, such individuals expecting to be repaid by the company, with interest. An advantage of lending-based crowdfunding is that the entrepreneur receives funding without giving away any ownership. In addition, similar to what often occurs with donation- and reward-based crowdfunding, the start-up's lenders may become its advocates via positive word-of-mouth and promotion on social media. Although it is an avenue of funding that can often be pursued when traditional avenues of debt financing cannot—lending-based crowdfunding does still, in fact, represent debt financing. As such, a substantial amount of this chapter's discussion of lending-based crowdfunding is included in the section on "Debt" presented later in the chapter.

Mentioned earlier in this chapter, equity crowdfunding is the accumulation of small amounts of capital from a large number of individuals via a campaign on the internet, such individuals obtaining an equity (ownership) position in the company as a result of their investment. Under U.S. federal law, the sale of securities to the public as an investment is regulated by the Securities and Exchange Commission (SEC). Among other responsibilities, the role of the SEC is to protect individual investors. The SEC, however, generally views accredited investors (generally, individuals making over $200,000 per year in income or having a net worth greater than $1 million, excluding their primary residence) as savvy enough to take care of themselves when it comes to investing—or wealthy enough to hire someone financially sophisticated to invest their money for them. A general partner, executive officer, or director of a company issuing a **security**—a negotiable financial instrument whereby an investor or lender expects to derive a profit or income—is also considered an accredited investor with regard to that particular company. As previously mentioned, angel investors are typically accredited investors.

In 2012, the Jumpstart Our Business Startups (JOBS) Act became law. Title III of that law created a need for the SEC to write rules regarding the registration, disclosure, and compliance requirements related to equity and lending-based crowdfunding. Specifically, the Act tasked the SEC with creating a structure for equity and lending-based crowdfunding that exempted it from some of the more burdensome regulations that restrict nonaccredited investors from purchasing the non-SEC-registered securities often offered by entrepreneurial start-ups. The typical participant in equity or lending-based crowdfunding is *not* an accredited investor. The challenge of developing regulations that allowed for

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equity and lending-based crowdfunding while still providing protections to its participant investors absorbed much of the SEC's attention for several years.

In October of 2015, the SEC finally promulgated the rules necessitated by Title III of the JOBS Act, thus giving nonaccredited investors the opportunity to invest in start-up companies via crowdfunding. In other words, in 2015, via **Regulation Crowdfunding** (SEC rules—which apply to both equity and lending-based crowdfunding—that allow companies to offer and sell, within certain guidelines and subject to certain limitations, up to $5 million of their securities within a 12-month period without having to register the offering with the SEC), the SEC created a path for average individuals to become private investors in start-up companies marketing themselves on the internet.[38,39,40] The primary motivation for allowing nonaccredited investors access to equity and lending based crowdfunding was the federal government's desire to open up a new source of capital for entrepreneurs—entrepreneurs being the individuals who created the companies that were responsible for generating approximately two-thirds of U.S. net new jobs from 1995 through 2021—a trend that continues today.[41,42]

There are limits on the amount nonaccredited investors can invest in equity and lending-based crowdfunding. If either your annual income or your net worth is less than $124,000, then during any 12-month period, you can invest up to the greater of either $2,500 or 5% of the greater of your annual income or net worth.[43] If both your annual income and your net worth are equal to or more than $124,000, then during any 12-month period, you can invest up to 10% of annual income or net worth, whichever is greater, but not to exceed $124,000.[44]

Aside from the above-noted challenge for investors participating in equity or lending-based crowdfunding, the SEC's Regulation Crowdfunding rules also present the following challenges and limitations for the entrepreneurs who wish to use equity or lending-based crowdfunding to pursue financing for their young or start-up companies:

- As is true for almost all crowdfunding campaigns, including donation- and reward-based crowdfunding, if a company does not raise the full amount of their funding goal, the company usually does not get to keep any of the money raised—and they lose the money spent on the up-front costs associated with pursuing the crowdfunding campaign. Some platforms do allow a company to receive the funds raised via a crowdfunding campaign, even if the company does not raise the full amount of their funding goal.[45] The circumstances under which this is permitted are limited, however, and usually involves the company forfeiting either a significant percentage of the funds raised or paying hefty fees.
- The SEC requires all transactions under Regulation Crowdfunding to take place online through an SEC- and Financial Industry Regulatory Authority (FINRA)-registered intermediary, either a broker-dealer or a funding portal. According to the SEC, if your business is a sole proprietorship, partnership, corporation, limited liability company, or other organized entity that is not registered (and does not intend to register) as a broker-dealer, but wishes to act as an intermediary in crowdfunding transactions, it must register with the SEC on the SEC's Form Funding Portal.[46] A registered funding portal is prohibited from:
  - Offering investment advice or recommendations
  - Soliciting purchases, sales or offers to buy the securities displayed on its platform
  - Compensating employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its platform
  - Holding, managing, possessing, or handling investor funds or securities[47]

  If a business entity plans to engage in any of the above activities and wishes to act as an intermediary in crowdfunding transactions, it must register as a broker-dealer rather than as a funding portal.[48]
- Not knowing if their company will have a successful crowdfunding campaign, the founders will need to spend time and money to meet the initial financial and other disclosure requirements of the SEC by filing a Form C.

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A Form C is an offering statement that must be filed by any company conducting a Regulation Crowdfunding offering. Form Cs are submitted through the SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) online filing system. Form C includes detailed financial and other information about the company and the offering.[49] The company must make additional informational filings, via Form C-U, after reaching 50% and 100% of its targeted offering amount.[50]

Beyond the required initial and intermediate disclosures outlined above, a company that has sold securities in a Regulation Crowdfunding offering is required to provide an annual report to the SEC on Form C-AR no later than 120 days after the end of its fiscal year.[51] The report must also be posted on the company's website. The annual report requires information similar to what is required in Form C. Issuers must comply with the annual reporting requirement until one of the following occurs:

- the company is required to file reports under Exchange Act Sections 13(a) or 15(d)
- the company has filed at least one annual report and has fewer than 300 holders of record
- the company has filed at least three annual reports and has total assets that do not exceed $10 million
- the company or another party purchases or repurchases all of the securities issued pursuant to Regulation Crowdfunding, including any payment in full of debt securities or any complete redemption of redeemable securities
- the company liquidates or dissolves in accordance with state law[52]

How much meeting all of the financial and other disclosure requirements associated with forms C, C-U, and C-AR will cost depends upon what exactly the SEC requires considering the particular situation at hand and how much of the work the founders do themselves versus outsourcing it.

Effective March 15, 2021, Regulation Crowdfunding rules limit start-ups to raising only up to $5 million within a period of 12 months, up from the previous fundraising limit of $1.07 million within a period of 12 months.[53,54] This $5 million limit can be a problem because the size of the average **seed round**—a seed round is typically a start-up's first significant seed capital received from a source other than the founders or their friends and families—has been steadily increasing in size in the United States. According to Crunchbase, in the first quarter of 2023, the median seed round in the United States was $2.3 million.[55] While the size of the average seed round is currently well below the Regulation Crowdfunding cap, the Regulation Crowdfunding cap is still low enough that, inevitably, some founders will need to pursue additional funding in parallel or in sequence to pursuing crowdfunding. This will, of course, require the investment of more money and more time on the part of the start-up and its founders.

- Due to the additional compliance requirements and perceived liability associated with having nonaccredited investors, it may be difficult for companies looking to do subsequent rounds of financing to bring in venture capital investment after a successful Regulation Crowdfunding campaign.

  A company's **capitalization table** outlines the entire debt and equity structure of the business, as well as the order in which investors and lenders will be satisfied in the event of a company's liquidation. An uncomplicated capitalization table is deemed preferable by many potential investors because the more investors and lenders an entrepreneurial venture has, the harder it is to push through major company initiatives.

  It should be noted, however, that some argue that a successful Regulation Crowdfunding campaign increases the likelihood of a company obtaining venture capital investment because a successful crowdfunding campaign can draw a lot of attention to a small company and demonstrate that a company has achieved traction, thereby increasing the attractiveness of the company's brand.

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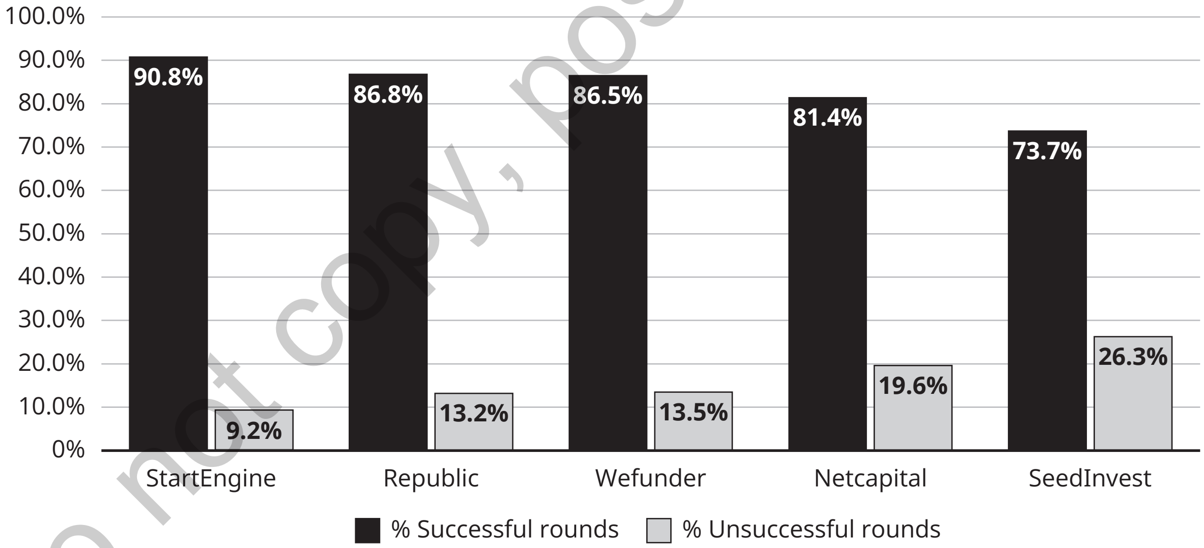
Turning our focus now to equity crowdfunding specifically, like all investments in start-ups, an investment in equity crowdfunding is considered high risk. There is no guarantee that a new start-up will succeed, and if the company fails, the equity shares will become worthless. Further, like most shares sold through **private placements** (the sale of securities directly to a private investor, rather than as part of a public offering), according to **Rule 144 of the Securities Act of 1933** (a rule that, under limited circumstances, provides an exemption from SEC registration requirements and permits for the resale of restricted or controlled securities, such as those issued in a private placement), the shares of stock purchased via equity crowdfunding cannot be sold (in most instances) for at least one year.[56] Beyond that, there is generally no marketplace for these shares—and there may never be—unless a company is successful enough to decide to register with the SEC and become a public company, or unless a functional secondary market for crowdfunding securities emerges. Even if a company plans to go public, it still usually takes many years before a company's initial investors can sell their shares. Data from CrunchBase indicates that the average time it takes for a start-up company to go public (considering only those companies who actually choose to pursue this path) is 8.25 years.[57]

At the writing of this textbook, several European equity crowdfunding platforms have, on an extremely limited basis, introduced secondary markets for their investors' securities. While it cannot by any means be said that these platforms have successfully created a functional secondary market for equity crowdfunding securities, the possibility does exist that in time, they—and other platforms like them—might.[58]

Overall, equity crowdfunding has made a huge difference for a lot of start-ups since 2015. During 2022, a total of $494 million was raised through equity crowdfunding over 33 active platforms, with StartEngine, Republic, and WeFunder being the most popular and, as illustrated in Figure 2.3, most successful platforms.[59,60]

Figure 2.3 ▪ Success rates of the top five equity crowdfunding platforms (2022).



Source: Adapted from: "Deal Success Across Top 5 Equity Crowdfunding Platforms" by Yasmin Sharbaf, Kingscrowd, June 22, 2022.

There were 394,354 reported equity crowdfunding investments in 2022 at an average investor check size of $1,256.[61] With the March 2021 increase in the Regulation Crowdfunding cap to $5 million and the creation of well-organized and efficient crowdfunding platforms like StartEngine, Republic, and WeFunder, the future of equity crowdfunding does, indeed, look bright. That said, given the hurdles and risks associated with equity crowdfunding, many entrepreneurs will likely choose to pursue more traditional avenues of funding, like those offered by Regulation D and Regulation A, which will be discussed later in this chapter.

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Note that the information included above regarding equity and lending-based crowdfunding is general in nature and any entrepreneur interested in offering securities via equity or lending-based crowdfunding should investigate the details outlined at sec.gov. In addition, note that every company must comply with applicable state securities laws and regulations in the states in which any securities are offered or sold.

Debt

LO 2.4	Identify the sources of debt financing available to a U.S. start-up venture.

Debt is a well-known and often used means of raising capital. The most attractive aspect of debt is that it does not generally involve giving away ownership of your company or a percentage of its profits. The least attractive aspect of debt is that, unless it converts into an equity investment, it must eventually be repaid, usually with interest.

At the beginning of this chapter, it was noted that, among other sources, the founders themselves, their friends and families, angel investors, venture capital funds, and CDFIs may all be sources of debt capital for a young venture. It is important to note that the promissory notes and other, more sophisticated debt instruments like convertible notes issued by young ventures in exchange for borrowed funds are, in fact, securities, and are therefore, in many instances, subject to federal and state securities laws. **Convertible notes** are securities that document the terms of an investor's loan to a company but also include an option for the investor to convert the loan into an equity position in the company if desired by the investor at a future point in time. Convertible notes are a tool commonly used by entrepreneurs to attract angel investors.

Potential sources of debt capital beyond the founders themselves, their friends and families, angel investors, venture capital funds, and CDFIs include:

- consumer credit
- banks and commercial lenders
- SBA loans
- Capital Access Programs (CAPs)
- lending-based crowdfunding

Most new businesses utilize some type of consumer credit in the form of either personal (founder) credit cards or business credit cards. It should be noted that the reward systems and the costs (annual fees, other fees, and interest rates) associated with credit cards vary widely. Repayment terms also vary. An entrepreneur should take the time to find a personal or business credit card that makes the most sense overall considering all of the costs involved and all of the rewards provided. Also, the entrepreneur will have to make a decision regarding the treatment of any personal credit card use for the benefit of her start-up. An entrepreneur can make the decision to treat the use of her personal credit card for the benefit of her start-up as a loan to be repaid by the start-up at a later date. Alternatively, the entrepreneur can make the decision to treat the use of her personal credit card for the benefit of her start-up as an equity investment in that start-up. Either way, the use of a personal credit card to benefit an entrepreneur's start-up should be clearly documented for later follow-up.

In general, beyond issuing credit cards, banks loan money to businesses in the form of either term loans, equipment (or asset) loans, or lines of credit. Term loans involve borrowing a lump sum of cash that is repaid, with interest, over a predetermined period of time. A downside of term loans is that they can be hard for a start-up business to obtain—especially a start-up business with few or no assets or little or no revenue. Equipment (or asset) loans typically finance a significant portion of a major asset

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purchase. The repayment term of the loan often mirrors the expected life of the asset, and the asset serves as collateral for the loan. A downside of asset loans is that they usually require that the start-up have the necessary down payment for the asset purchase. This can be a challenge for many young ventures. A business line of credit provides access to funds up to a pre-established credit limit. Interest is paid only on the amounts borrowed, like a credit card, so a line of credit can offer flexibility that term and asset loans cannot. Downsides of business lines of credit include the need for the business to have established good credit before applying for the line and, often, the need for the business to pay down the line to $0 at least once each year.

Although small, local banks are sometimes friendlier than large banks, in general, banks are risk-averse and not receptive to lending to start-up companies, especially those that have no significant assets or revenues. If a business has no assets or no revenues and is seeking a loan from a typical bank, the bank is likely to ask the entrepreneurs involved to either personally guarantee the loan or pledge specific personal assets as collateral for the loan. As a practical matter, both of these practices compromise the goal of keeping the entrepreneur separate from her business discussed in Chapter 1 and should, therefore, be avoided if at all possible.

New research from Codat, a leading application programming interface for small business data, shows that over one fifth of U.S. small- and medium-sized businesses surveyed couldn't access 100% of the credit they needed in 2022.[62] Because of the difficulties many entrepreneurs and small business owners encounter when trying to get a loan, they often enlist the help of the SBA. The SBA doesn't make loans to start-ups. It does, however, work to facilitate loans to small businesses via its 7(a) Loan Program.[63]

When a business applies for an SBA loan, it is actually applying for a commercial loan from one of the SBA's lending partners, structured according to SBA requirements. The SBA then guarantees that the loan will be repaid (up to a specified percentage), thus eliminating some of the risk to its lending partner.[64] The 7(a) loan program is SBA's primary program for providing loans to small businesses. The terms and conditions for 7(a) loans vary by type of loan, which include Standard 7(a) loans, 7(a) Small loans, SBA Express loans, Export Express loans, Export Working Capital loans, International Trade loans, and CAPLines loans.[65] For a standard 7(a) loan of $500,001 to $5 million, the SBA guarantees up to 75% of the loan amount. For a 7(a) small loan with a maximum loan amount of $500,000, the SBA guarantees up to 85% of a loan of $150,000 or less, and up to 75% of a loan above $150,000.[66]

To be eligible for 7(a) loan assistance, a business must, in general, be an operating, for-profit business located in the United States that meets the SBA's definition of a small business. (The SBA's definition of a small business varies by industry and is based on a company's North American Industry Classification System (NAICS) code. For more details regarding the SBA's definition of a small business, see https://www.ecfr.gov/current/title-13/chapter-I/part-121.) The business must not be able to obtain the desired credit on reasonable terms from nonfederal, nonstate, and nonlocal government sources and the business must be creditworthy and be able to demonstrate a reasonable ability to repay the loan. The business must also not be an ineligible business as defined by Title 13 of the U.S. Code of Federal Regulations.[67] (For details regarding what businesses may be ineligible for 7(a) loan assistance according to Title 13, see https://www.ecfr.gov/current/title-13/chapter-I/part-120/subpart-A/subject-group-ECFR6d9c2c4fd6e44c1/section-120.110.) You can learn more about the SBA's 7(a) loan program at sba.gov.

A Capital Access Program (CAP) is a loan portfolio insurance program that makes it possible for banks to provide loans to small businesses they might otherwise reject. The insurance aspect of the program works such that, when a loan is made, the lender and borrower each contribute a percentage of the loan—such contribution typically ranging from 2% to 7% of the total loan amount—into a reserve fund held by the lender.[68] The state then matches the combined lender/borrower contribution. Each participating lender's total CAP reserve fund is then available to cover losses on any loan in the lender's CAP portfolio. CAPs offer banks the flexibility to make loans that may not qualify for an SBA guarantee. CAPs offer entrepreneurs the ability to get a loan more quickly than they often can through the SBA. In order to determine if a CAP exists in your state, check with your state's economic development agency.

Lending-based crowdfunding is a form of crowdfunding that is gaining increasing traction in the United States because it often facilitates debt financing for entrepreneurs who cannot borrow via other means. Lending-based crowdfunding takes place through internet platforms like SMBX, Mainvest,

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Honeycomb Credit, and LendingClub.com.[69] According to SCORE, a nonprofit organization that provides free and confidential business mentoring services to prospective and established small business owners across the United States, the typical annual interest rate related to lending-based crowdfunding in the United States is 5%-27%, with a typical repayment period of 6 months to 5 years.[70] Lending-based crowdfunding currently takes place in the United States in one of four basic forms: peer-to-peer (P2P) lending, micro-lending, mini-bonds, and invoice financing. P2P lending matches lenders with businesses seeking finance. The goal is that businesses pay lower interest rates than they would have to pay alternative sources of financing and lenders get a better return than that provided by a typical bank. Micro-lending is similar to P2P lending except the amounts borrowed are usually less than $50,000 and the borrowers tend to be small, distressed businesses that are often located in underserved communities.[71] Mini-bonds are still rather rare, but usually have a term of three to five years, require borrowers to make regular interest payments to lenders during that time, and then require the borrower to return 100% of the principal borrowed at the end of the bond term.[72] Invoice financing provides businesses with funding or a revolving line of credit based on the business's unpaid customer invoices.

Successful lending-based crowdfunding requires predictable cash flow to ensure a business's ability to make required interest payments and pay back the amount originally borrowed on schedule. And, as with all debt, debt amassed as a result of lending-based crowdfunding may limit a business's ability to pursue other financing options at a future date. Note that crowdfunding platform fees can be substantial depending on the platform, an individual business's creditworthiness, and the business's general financial condition. Last, it is important to note that, as mentioned earlier in this chapter, lending-based crowdfunding, like equity crowdfunding, is regulated by the SEC under its Regulation Crowdfunding rules. As a result, any entrepreneur interested in offering debt securities via lending-based crowdfunding should investigate the details outlined at sec.gov. In addition, note that every company must comply with applicable state securities laws and regulations in the states in which any securities are offered or sold.

In conclusion, securing debt financing for a start-up is not an easy task for the typical entrepreneur. And, beyond just determining a viable path for pursuing debt financing, the entrepreneur must also work to carefully structure any debt financing successfully obtained so that the debt optimally serves the needs of her start-up business. Best practices when structuring debt for a start-up business include:

- negotiating the ability to pay interest only for a period of months or years, ideally until the new venture gets past its start-up phase
- negotiating a fixed, rather than a variable, interest rate
- negotiating a long repayment term with the ability to repay early, if and when desired
- negotiating the ability to renegotiate interest rates, fees, and repayment terms, if and when circumstances change

Regulatory Considerations

LO 2.5	Discuss the fundamental differences between—and the regulatory considerations associated with—utilizing an initial public offering (IPO), Regulation A, Regulation D, or Regulation Crowdfunding to procure funding for a young venture.

Almost every path to securing capital for a young venture, other than perhaps the funding that comes from the entrepreneurs themselves, involves the issuance of a security. Stocks and bonds are easily identifiable as securities, but the SEC and most states also view an ownership interest in an LLC as a security. Similarly, a limited partnership interest is generally viewed as a security. Additionally, as

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mentioned previously, dependent upon the circumstances surrounding it, a promissory note or other document detailing debt financing from a nonbank entity can also be viewed as a security.

Prior to 1933, the U.S. securities markets were largely unregulated. The stock market crash of 1929 and the Great Depression it precipitated led to the promulgation of the Securities Act of 1933 and the Securities and Exchange Act of 1934. The Securities Act of 1933 is most relevant to new ventures in that it pertains to the initial offering of securities by a company and the continuing disclosures that must be made once those securities have been issued. The Securities and Exchange Act of 1934 regulates the exchange of securities after they have been issued. Both Acts require that very specific filings be made with the SEC. Such filings can involve the formal registration statements and prospectuses associated with a company offering securities to the public for the first time. Ongoing filings can involve the submission of quarterly financial information and complete annual reports that include audited financial statements.

Beyond the requirements of the 1933 and 1934 federal Acts, state security laws known as "blue sky laws" also exist. Although every state in the United States has securities laws, the laws are not uniform from state to state and sometimes conflict somewhat with federal securities laws. This can sometimes make complying with all of the securities laws applicable to a particular company—or a particular security issued by a company—very challenging. A point that cannot be stressed enough is that, *before an entrepreneur ever thinks of taking either debt or equity capital from an investor—including family, friends, angel investors and venture capital investors—the entrepreneur must thoroughly investigate the implications of taking that capital considering the nature of the security to be issued in exchange for the capital and the federal and state securities laws that may affect that security*. Unless the entrepreneur happens to be a CPA or an attorney, this usually means contracting the services of a CPA or an attorney.

Earlier in this chapter, there was a discussion of Regulatory Crowdfunding, which applies to both equity and lending-based crowdfunding and usually involves raising funds via internet-based funding portals regulated by both the SEC and FINRA. Both equity and lending-based crowdfunding generally involve the filing of initial and intermediate disclosures with the SEC via Form C and Form C-U and the filing of an annual report with the SEC via Form C-AR. The annual reporting requirement can continue for many years, dependent upon the circumstances surrounding the company that did the crowdfunding raise and the crowdfunding raise itself. The costs associated with the filing of Form C, Form C-U and Form C-AR with the SEC vary dependent upon what exactly the SEC requires considering the particular instance at hand and how much of the work the founders do themselves versus outsourcing it.

Because of the time, money, and effort generally required to comply with securities laws, entrepreneurs often choose to pursue funding via paths that either avoid the need to register securities with the SEC or minimize the need to report information to the SEC. There are two general paths to avoid registering securities with the SEC: issuing exempt securities and participating in exempt transactions. Exempt securities include, among others, government securities, insurance policies, and **commercial paper**—an unsecured, short-term debt instrument, typically issued in a large denomination ($100,000 or more) by a large bank, a foreign government, or a large corporation with a strong balance sheet, the proceeds of which are typically used to finance accounts receivable or inventory or to meet short-term debt obligations. Exempt transactions include purely **intrastate offerings**—securities whose sale is limited to investors in one state—and certain private placements. The amount of money that can be raised with an intrastate offering—and the amount of time permitted to do so—varies by state. As a result, before attempting any intrastate offering, the applicable state's securities laws should be consulted. The exemption related to private placements is best described in an amendment to the Securities Act of 1933 called Regulation D.

Regulation D

Regulation D is a regulation that allows companies to raise capital through the issuance of securities without having to register those securities with the SEC.

Regulation D contains Rules 504 and 506. The only filing requirement associated with each of these rules is to file a Form D with the SEC and certain states (as required by those states). Form D must be filed within 15 days of the first sale of the securities in an offering.[73] The main purpose of Form D is to notify federal and state authorities of the amount and nature of the offering being pursued

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under Regulation D. It is via Regulation D that many angel investors acquire their equity positions in young companies.[74]

Under *Rule 504* of Regulation D, certain issuers may offer and sell up to $10 million of securities to any type of investor in any 12-month period.[75,76] An issuer is not subject to specific disclosure requirements for securities offered under Rule 504 except that the company must take care to provide sufficient information to investors to avoid violating the antifraud provisions of securities laws and any information the company provides to investors must be free from false or misleading statements.[77]

Under *Rule 506* of Regulation D, certain issuers may offer and sell an unlimited amount of securities by relying on one of two possible exemptions: Rule 506(b) and 506(c):

> Issuers relying on *Rule 506(b)* may sell to an unlimited number of accredited investors, but to no more than 35 non-accredited investors. Note, however, that the non-accredited investors included in the offering must be financially sophisticated or, in other words, they must have sufficient knowledge and experience in business and financial matters to be able to effectively evaluate the investment under consideration.[78] If the issuer offers securities to non-accredited investors, the issuer must disclose certain information about itself, including its financial statements. If selling only to accredited investors, the issuer has discretion as to what to disclose to investors. Any information provided to accredited investors also must be provided to non-accredited investors. Issuers relying on the Rule 506(b) exemption may not generally solicit their offerings.[79] In layman's terms, this means not disclosing the offering materials—or the existence or terms of the offering—to the general public, the press, or individuals with whom the company does not—or the company's founders do not—have a preexisting substantive relationship.[80] In 2019, out of the three Regulation D offering types, the most capital was raised by far under Rule 506 (b).[81]

> Issuers relying on *Rule 506(c)* can, in most instances, advertise their offerings to the general public via the internet, social media, television, radio, etc. Note, however, that only accredited investors are permitted to purchase securities offered under a Rule 506(c) offering that is widely advertised, and the issuer will need to be able to prove that reasonable steps were taken to verify accredited investor status.[82]

While a start-up wanting to raise capital still needs to provide the proper framework and disclosures when pursuing funding via a private placement under Regulation D, overall, the requirements are usually somewhat less than what is prescribed for Regulation Crowdfunding and always significantly less than what is prescribed for a public offering.

Conducting a public offering is a notoriously expensive and time-consuming process usually engaged in by a company well beyond the start-up phase. In other words, a public offering is generally outside the realm of possibility for the typical start-up company. When looking for major funding, considering the high cost associated with meeting SEC and other regulatory requirements, a typical start-up is most likely to consider Regulation D or Regulation Crowdfunding. The Resolution of Entrepreneur in Action 2.1 illustrates how Regulation D can often be an optimal means of pursuing funding for a young company.

Resolution of Entrepreneur in Action 2.1: Carrie Paxton's Business Funding Puzzle

When we left Carrie, she was feeling unsure about the best source of the $1 million needed to fund the growth of her company, MedPet. She and her business partners had agreed they didn't want to borrow to get the $1 million the company needed—so there was consensus on that issue. The challenge was that each of her partners had a different idea for how to obtain the needed funds. Darnell favored pursuing an equity crowdfunding campaign, Jamal favored pursuing a venture capital investment, and Kristin favored pursuing an angel investment. After

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thinking about what her business partners had said, Carrie suggested to all of her partners that they and she meet the next day in MedPet's main conference room to come to an agreement on the best means to raise the $1 million.

Carrie's partners came to the meeting prepared. Darnell regaled his three business partners with crowdfunding success stories—stories about the successful funding of the *I'll Be Next Door for Christmas* movie, the BrewDog brewery, and Paradox Interactive. Jamal told a story about how an entrepreneur friend of his had recently landed a $2.5 million investment in his company from a local venture capital group—and how his friend was thrilled with having the cash he needed and with having the venture capitalists as advisors for his business. Kristin told a story similar to Jamal's, except it was about an entrepreneur friend who had recently landed a multimillion-dollar investment from a local angel group.

When it was her turn to speak, Carrie tackled Jamal's venture capital suggestion first and said that she appreciated the fact that venture capital investment can work well for some companies. She then said, "What happens if the venture capitalists' vision for the future of MedPet doesn't match ours?" Carrie's business partners looked at each other. The room was silent. Next Carrie lauded the obvious success of all the crowdfunding campaigns Darnell had mentioned, but then also said, "Darnell, the investors who participate in equity crowdfunding obtain an ownership position in a company as a result of their investment in that company. Our company is currently limited to us four owners. Do we really want to deal with hundreds or, potentially, thousands of new owners?" Not giving Darnell an opportunity to interrupt, Carrie quickly pressed on saying, "I did a lot of research last night. I also thought about who we are as business owners—what our preferences and priorities are. All in all, I think it's best for us to pursue the funding we need via angel investment using Regulation D."

Darnell said, simply, "Why?"

Carrie continued on, "Seeking funding under Rule 504 of Regulation D would allow us to raise the $1 million of capital we need without having to register with the SEC. The only filing requirement for our company associated with Rule 504 is to file a Form D with the SEC. Using Regulation D would allow us to pursue funding from just a few accredited investors—angel investors—instead of hundreds or thousands of investors via equity crowdfunding. This just makes sense for us, I think, if we want to keep the number of owners of MedPet low. Also, seeking funding via angel investment instead of venture capital investment allows us to maintain maximum control over the future of our company—which I think we all want—while still receiving the benefit of advice from those who invest in our company.

Darnell looked at Carrie, then at his other business partners, then back at Carrie. "Well," he said, "I'm impressed. You've clearly done your research and really thought about this, Carrie, and you've convinced me. Pursuing the funding we need via Regulation D has my vote." The other owners of MedPet nodded in agreement.

Note that the information included in this section regarding Regulation D is general in nature and any entrepreneur interested in offering securities under Regulation D should investigate the details outlined at sec.gov. In addition, note that every company must comply with applicable state securities laws and regulations in the states in which any securities are offered or sold.

Regulation A and Regulation A+

While Regulation D allows a company to avoid formally registering with the SEC altogether, **Regulation A** is a regulation that allows an exemption from certain registration requirements of the SEC.

Regulation A is usually utilized by young companies that are beyond the start-up phase and seeking funding for growth. Companies utilizing the Regulation A exemption must still file offering statements with the SEC and give potential buyers documentation similar to the prospectus associated with a registered offering; however, companies utilizing the exemption enjoy more limited disclosure requirements than publicly reporting companies.

The original Regulation A exemption related to public offerings of securities that did not exceed $5 million in any 1-year period. 2015 updates to Regulation A (creating what is commonly referred to as "**Regulation A+**") allow companies to pursue public offerings under the following two tiers:

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1. *Tier 1*: Companies offering securities under Tier 1 can offer up to $20 million in any 1-year period. The issuing company must provide an offering circular to the potential investor. That circular must be filed with the SEC and is subject to review and qualification by both the SEC and the securities regulators of the individual states in which the offering is being conducted. The financial statements disclosed in a Tier 1 offering are not required to be audited.[83] Companies are required to issue a report on the final status of the offering, but they are not required to continue to report to the SEC on an ongoing basis.[84]

2. *Tier 2*: Companies offering securities under Tier 2 can offer up to $75 million in any 1-year period.[85] As with Tier 1, the issuing company must provide an offering circular and that circular must be filed with SEC, which will review it and may qualify it. What is different for Tier 2 is that the offering circular is not subject to a vetting process by the securities regulators of any individual state. Instead, companies offering securities under Tier 2, in addition to issuing a report on the final status of the offering, become subject to ongoing SEC reporting requirements.[86] Further, the financial statements disclosed in a Tier 2 offering have to be audited by an independent accountant.[87] Recent estimates suggest that 70% of all Regulation A-based offerings are registered under Tier 2.[88]

There are no limitations regarding who can invest—or how much they can invest—in an offering under Tier 1 of Regulation A. There are limitations regarding how much certain individuals can invest in an offering under Tier 2. Generally, if the potential investor is not an accredited investor and the securities in question are not going to be listed on a national securities exchange, the investor may invest no more than 10% of the greater of her annual income or net worth, excluding primary residence.

Similar to those that exist to support crowdfunding, online funding portals exist for Regulation A raises. Examples include Dalmore Group, StartEngine, and SeedInvest.[89,90] Note that StartEngine acquired SeedInvest in May of 2023.

Note that the information included above is general in nature, and any entrepreneur interested in offering securities under Regulation A should investigate the details outlined at sec.gov. In addition, note that every company must comply with applicable state securities laws and regulations in the states in which any securities are offered or sold.

IPO vs. Regulation A vs. Regulation D vs. Regulation Crowdfunding

A traditional initial public offering is designed for a large, mature company that has the resources needed to cover the significant accounting and legal expenses associated with "going public." Regulation A gives a smaller company the ability to make a limited-size public offering, including the ability to list Tier 2 offerings on securities exchanges like the Nasdaq Stock Market (commonly referred to as NASDAQ) and the New York Stock Exchange (NYSE). For this reason, a Tier 2 Regulation A offering is sometimes called a "mini-IPO." In other words, Regulation A essentially represents the middle ground between a private placement under Regulation D and a public offering in the form of a full-scale IPO.[91]

In certain ways, however, Regulation A actually has more in common with a traditional IPO than Regulation D. Most important, perhaps, is *the ability of a Regulation A offering to act as a liquidity event for early-stage investors.* The "secondary sales" process associated with Regulation A allows for up to 30% of the securities sold during a public offering to originate from a company's current securities holders.[92] Issuing securities under Regulation A, therefore, is often a viable option entrepreneurs can suggest to potential angel and venture capital investors as a means for those investors to exit their investment in a start-up at some time in the future, should they desire to do so.

Compared to Regulation A, Regulation D offerings have always been more popular among young companies needing to raise funding. For example, in 2019, under Regulation A, there was only approximately $1 billion raised, while under Regulation D over $1.5 trillion was raised.[93] In addition, for a start-up seeking investment, recent estimates put the average cost for a Regulation D raise at 10-12% of the capital raised, slightly lower than the average cost of 12% of the capital raised for Regulation A.[94]

As discussed in detail earlier in this chapter, Regulation Crowdfunding offers a whole new alternative to the traditional paths of IPO, Regulation A, or Regulation D. Whether accomplished via equity

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or lending-based crowdfunding, in addition to raising funding, Regulation Crowdfunding allows a start-up to potentially reach a very large number of small dollar investors and potentially gain brand awareness—and a customer base—along the way.

Before Regulation Crowdfunding gained momentum in the early 2020's, Regulation D was generally considered the most inexpensive and time efficient means for most start-ups to raise needed funding outside the realm of friends and family.[95] However, for a start-up seeking investment, recent estimates put the average cost for a Regulation D raise at 10-12% of the capital raised versus an average cost of 5.3% of the capital raised for a Regulation Crowdfunding campaign.[96] Also, the time between deciding to pursue funding and actually receiving that funding is estimated to be, on average, a month less for funding pursued via Regulation Crowdfunding versus Regulation D.[97] Clearly, although the SEC has reported a steady growth in Regulation D offerings during the last few years, Regulation Crowdfunding has changed the game in terms of how many existing and future start-up entities will choose to meet their outside funding needs.[98]

Summary

LO 2.1 Identify the common sources of funding available to a typical U.S. start-up venture.

- providers of equity or debt capital, such as:
  - the founders themselves
  - friends, family, and "fools"
  - angel investors
  - venture capital funds
  - CDFIs
- providers of equity capital only, such as participants in equity crowdfunding
- providers of debt capital only, such as:
  - banks and a variety of other lenders
  - participants in lending-based crowdfunding
- providers of capital that is neither equity capital nor debt capital:
  - grant-issuing governmental agencies and public and private trusts and foundations
  - participants in donation- or reward-based crowdfunding

LO 2.2 Explain the nature of the typical investment in a U.S. start-up venture by angel investors, venture capital funds, Community Development Financial Institutions (CDFIs), and providers of grants.

Angel investors, usually successful or retired entrepreneurs or businesspeople, invest either debt or equity capital—or some combination of both—in start-ups and early-stage companies and also often provide free mentoring to the companies in which they invest. Venture capital funds typically invest in high-potential or high-growth start-up companies, usually in one of the technology industries. While it can involve a component of debt, a venture capital investment is typically an equity investment that occurs as the first sophisticated round of investment capital after a young entity's seed capital has already been provided. CDFIs aim to expand economic opportunity in low-income communities by providing financing, usually in the form of a loan or some type of loan support, to businesses that support local economic development activity, especially those businesses that create local jobs or affordable housing. Grants are monies provided to an individual or an entity that do not have to be repaid to the provider of the monies as long as the receiver of the monies provides the goods or performs the services for which the grant was approved. In the United States, grants are most often issued by governmental agencies and a wide range of public and private trusts and foundations.

LO 2.3 Describe the differences between—and the challenges associated with—donation-based, reward-based, lending-based, and equity-based crowdfunding.

Crowdfunding involves the accumulation of small amounts of capital from a large number of individuals via a campaign on the internet, such individuals expecting nothing

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in return (donation-based crowdfunding), expecting very little in return other than a news update, small gift, or product or service, usually of nominal value (reward-based crowdfunding), expecting to be repaid by the company, with interest (lending-based crowdfunding), or expecting an ownership interest in the company (equity crowdfunding).

If a company does not raise the full amount of their funding goal, the company usually does not get to keep any of the money raised via crowdfunding—and they lose the money spent on the up-front costs associated with pursuing the crowdfunding campaign. In addition, with regard to lending-based and equity-based crowdfunding only, among other challenges, not knowing if their company will have a successful crowdfunding campaign, the founders will need to spend time and money to meet the initial financial and other disclosure requirements of the SEC by filing a Form C. Also, SEC rules limit start-ups to raising only up to $5 million within a period of 12 months, and there are limits to the amount non-accredited investors can invest.

LO 2.4 Identify the sources of debt financing available to a U.S. start-up venture.

Potential sources of debt capital beyond the founders themselves, their friends and families, angel investors, venture capital funds, and CDFIs include:

- consumer credit
- banks and commercial lenders
- SBA loans
- Capital Access Programs (CAPs)
- lending-based crowdfunding

LO 2.5 Discuss the fundamental differences between—and the regulatory considerations associated with—utilizing an initial public offering (IPO), Regulation A, Regulation D, or Regulation Crowdfunding to procure funding for a young venture.

While Regulation D allows a company to avoid formally registering with the SEC altogether, Regulation A allows exemption from certain registration requirements of the SEC for entities whose offerings qualify under two SEC-specified tiers. Regulation A essentially represents the middle ground between a private placement under Regulation D and a public offering in the form of a full-scale IPO—the latter being very expensive to pursue, in part because a successful IPO usually requires the assistance of a team of CPAs and attorneys to meet SEC and other regulatory requirements.

Regulation Crowdfunding offers a whole new alternative to the traditional paths of Regulation D, Regulation A, or IPO. Before Regulation Crowdfunding gained momentum in the early 2020's, Regulation D was generally considered the most inexpensive and time efficient means for most start-ups to raise needed funding outside the realm of friends and family. However, for a start-up seeking investment, recent estimates put the average cost—and the average time between deciding to pursue funding and actually receiving that funding—at being less for a Regulation Crowdfunding raise than for a Regulation D raise.

Review and Discussion Questions

1. What are the common sources of funding available to a typical U.S. start-up venture?
2. What is the profile of a typical angel investor, and in what type of companies do angel investors usually like to invest?
3. Explain the nature of a typical venture capital investment.
4. Aside from the many challenges for the investor participants in Regulation Crowdfunding, Regulation Crowdfunding also presents many challenges for the companies that wish to raise funds using the platform. Describe these challenges.
5. In general, banks are risk-averse and not receptive to lending money to start-up companies, especially those that have no significant assets or revenues. Considering this fact, what

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alternative sources of debt financing—beyond the founders themselves, their friends and families, angel investors, venture capital funds, and CDFIs—are often available to a start-up? What are some of the main attributes of these alternative sources of debt financing?

6. Many entrepreneurs choose to pursue sources of funding under the auspices of Regulation D, Regulation A, or Regulation Crowdfunding. What are the fundamental differences between these three sources of funding and an IPO? How does issuing securities under Regulation D compare of late to issuing securities via Regulation Crowdfunding?

Exercises

1. A common source of funding for a start-up venture is friends, family, and "fools." Brainstorm and come up with an idea for a new app. Flesh out the idea into a full business model (see Chapter 1) that describes how you would make money with the app. Assume you do not have enough resources available to you to execute the concept on your own and need an investment of $50,000 to develop and launch the app. Interview five of your family members or friends. After explaining the app to them, which of them would be willing to invest in a company created by you to bring the app to market? How much would they be willing to invest, and what would they want in exchange for their investment? If they are not willing to invest, why not? Write a two-page paper describing the app and describing the results of your interviews with your family members or friends regarding investing in your imaginary company.

2. Angel investors are a common source of funding for start-up ventures. Go to angelcapitalassociation.org. Find an angel investor or an angel investor group that is in your state. Explaining that you are an entrepreneurship student seeking to learn about angel investors, contact the angel investor—or a member or leader of the angel investor group you have chosen—asking them for a short phone interview. During the interview, ask the angel about his or her background and how he or she came to be an angel investor. Ask the angel what he or she specifically looks for when deciding whether or not to invest in a start-up. Last, in light of his or her considerable experience, ask the angel for any advice he or she has for young entrepreneurs. Write 2-3 paragraphs describing how you came to choose the angel you interviewed and the results of the interview itself.

3. The SBA, CDFIs, and grant-issuing government agencies and public and private trusts and foundations are possible sources of funding for a start-up venture. Go to one or more of the following websites: sba.gov, cdfifund.gov, candid.org, and grants.gov. Write a one- or two-page paper describing the funding opportunities available in your area for a business concept you may be interested in pursuing in the future. If you don't have a specific business concept in mind, describe the funding opportunities available in your area for an industry in which you are interested (e.g., fashion, entertainment, hospitality, computers and technology, transportation, education, etc.). Be sure to clarify in your paper the business concept or industry in which you are interested.

4. Equity crowdfunding campaigns are a possible source of funding for a start-up venture. Recent successful equity crowdfunding campaigns include those executed by the following companies: Mercury (mercury.com); Replit (replit.com); Maven (maven.com); Beta Bionics (betabionics.com); and Heliogen (heliogen.com). Mercury, Replit, and Beta Bionic used the Wefunder (wefunder.com) crowdfunding portal to execute their equity crowdfunding campaigns. Maven used Republic (republic.com). Heliogen used SeedInvest (seedinvest.com). Either via its company website, the applicable equity crowdfunding portal, or some alternative means, investigate two of the five companies mentioned in the second sentence of this exercise. Write 2-3 paragraphs explaining the merits of the applicable companies and why, if given the opportunity, you would have—or would not have—invested in the companies via their equity crowdfunding campaigns.

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5. Equity crowdfunding is a possible source of funding for a start-up venture. Review a reputable equity crowdfunding website (funding portal) of your choice (examples include StartEngine (startengine.com), Republic (republic.com), Wefunder (wefunder.com), Netcapital (netcapital.com), and SeedInvest (seedinvest.com)). Write 2-3 paragraphs describing the types of opportunities for investment available on the funding portal you have chosen. In what company, if any, would you invest? How much and why? If you cannot find a company in which you would invest, pick any company on the funding portal and then explain what steps would have to be taken by the company/funding portal in order to convince you to invest in that company.
6. Taking on debt is a possible source of funding for a start-up venture. Brainstorm and come up with an idea for a new app. Flesh out the idea into a full business model (see Chapter 1) that describes how you would make money with the app. Assume you do not have enough resources available to you to execute the concept on your own and need a loan of $50,000 to develop and launch the app. Explaining that you are an entrepreneurship student seeking to learn about the various sources of funding available to start-up businesses, interview two loan officers—each representing a bank that is local to you. After explaining the app to them, which of them would be willing to make a loan to a company created by you to bring your app to market? How much would each bank be willing to loan, and what restrictions/requirements would be attached to the loan(s), if any? If a bank would be unwilling to make such a loan, why? What suggestions for alternative funding does the bank have? Write a two- to three-page paper describing the app and describing the results of your interviews with the loan officers regarding making a loan to your imaginary company.

Key Terms

accredited investor
angel investor
bootstrapping
capitalization table
commercial paper
convertible note
debt capital
donation-based crowdfunding
equity capital
equity crowdfunding
grant
initial public offering (IPO)
intrastate offering
lending-based crowdfunding
private equity firm
private placement
proof of concept
public offering
Regulation A
Regulation A+
Regulation Crowdfunding
Regulation D
reward-based crowdfunding
Rule 144 of the Securities Act of 1933
security
seed capital
seed round
Series 7 license
Series A
small business investment companies (SBICs)
traction
venture capital firm
venture capital fund

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